Current problems of the West German Economy

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SUMMARY. *After dealing with a few characteristics of the West German economy as compared to the Danish economy, the author states a number of propositions concerning the future growth and structure of the former. He argues that growth rates of potential output will slow down and that structural unemployment will stay rather high during the next years. The recession of 1974/75 is shown to have been mainly due to stop and go monetary policies and notably to the choice of an anti-inflationary policy that was bound to collide with inflationary expectations.*

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1. Let me start by making six observations which characterize the West German economy in contrast to the Danish economy.

Observation one: The FRG has a lower per capita GNP. The difference was about one thousand DM until 1973; it increased to 1.300 DM last year, as Germany was one of the leaders in world recession. (The absolute figures are DM 17.300 for Denmark, 16.000 for the FRG.)

Observation two: The cyclically adjusted difference is totally due to a higher rate of participation of women in the Danish labour force, i.e. of married rather than unmarried women. If women had the same participation rate in Germany as in Denmark there would be 3.3 million more employed. This compares to 2.4 million guest workers in Germany in 1974.

Observation three: GNP per employed person is higher in Germany than in Denmark and higher also than in Sweden. In 1974 West Germany had the highest labour productivity in Europe, followed by the Netherlands, Switzerland, Sweden and Denmark. (This comparison could be considered misleading by those who believe that a labour force composed of relatively few women is bound to be more productive.)

Observation four: As regards taxation and social security contributions as a percentage of GNP (at factor costs) our countries had reached the same milestone

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in the march towards the welfare state in 1969 (41,5 %). We were in the same group with Austria, France and the UK, but had left Belgium, the US and Italy and, of course, Japan far behind. After 1969 Denmark and the other Scandinavian countries made a big jump ahead, while Germany kept a mid-position. The distance increased to almost 10 percentage points with 41 percent in Germany and 50.9 percent in Denmark. Germany may have moved ahead since 1971 but comparable figures are not available. We are presently trying hard to squeeze the public sector in order to give more incentives to private initiative.

Observation five: The difference in tax burden between our two countries has two reasons of equal importance. Almost five percentage points are accounted for by higher purchase taxes in Denmark. Only a little less is the additional burden which Denmark places on incomes in terms of taxes and social security contributions.

Observation six: As regards investment, most people tend to believe (as I did before I looked up the figures) that West Germany had a higher share of gross investment in GNP. This belief was justified until 1971. Since then Germany's rate of investment has slowed down to a ratio of 23 % in 1974, while Denmark's investment ratio stayed at the level of 28 %.

2. For the decline in the investment ratio, there may be a cyclical explanation about which I am going to talk later. Let me first state and substantiate some propositions concerning the future growth and structure of the West German economy.

Proposition one: The growth of productive capacity of potential output within the boundaries of the Feredal Republic will fall below what it has been in the last ten er twenty years. Instead of a growth rate of almost 5 percent in the sixties we should be happy to reach four percent in the next ten years. Perhaps, we shall have to be satisfied with the classical rate of 3 percent. Here is the chain of arguments:

(*a*) The part of total household and business savings which is channeled into domestic investment is likely to go down; more and more of it needs to be and will be invested abroad. One reason is the political decision based on a widespread public feeling that we should cease to attract more workers from abroad. If industrial labour becomes scarcer and more expensive in relation to capital we shall have to substitute capital for labour. But this is becoming more and more difficult. Hence there will be an increasing tendency for firms to shift production or certain processes in a production line to low wage countries, preferably in Europe. This would be most desirable for Europe as a whole, because contrary to North America there is less desire in Europe to destroy cultural diversity in favour of becoming a large economic melting pot. Instead of getting workers to the jobs we should bring jobs to the workers. A precondition for this, however, is probably that the countries with surplus labour join us in forming what may be called a Free Investment Area, i.e. a grouping of countries which agree to guarantee foreign investment from within the group against the risk of political expropriation. If political stability in Southern Europe is insufficient to let such guarantees appear credible, communist Europe is certainly politically stable enough and probably eager to absorb West German capital, not to speak of the People's Republic of China. All this is not to help greedy capitalists but to protect the mass of small savers and to enable the savings institutions once more to pay to their creditors an interest rate which is positive in real terms.

(*b*) A decrease in the inflow of foreign workers and a greater outflow of investment from West Germany seems also necessary and desirable for environmental reasons. The inflow of foreign workers was strongest into those regions which were already heavily industrialized. For a short time there had been a tendency for industry to be guided in its choice of location by labour market conditions. This greatly helped the backward and peripheral regions. But when it was seen that mobile workers from Southern Europe could be hired without any difficulty, industry again grew where it had grown in the past. This explains why there are some industrial areas in West Germany for which the fashionable thesis of the Club of Rome that the limits to growth have been reached was regionally right (although globally it seems wrong). As far as these areas are concerned, pollution charges and regulations will speed up the outflow of capital from Germany.

(*c*) The third reason supporting my proposition about slower growth of GDP in West Germany is the expectation of a further fall in the potential average productivity of investment. For this I have three arguments.

Firstly: An investigation at the Kiel Institute has shown that the productivity of capital or investment is smaller the larger the cyclical swings in output and employment.[1] We can definitely say that the German business cycle, in spite of all attempts to smooth it, has become larger in amplitude in the sixties than it was in the fifties, and if I may extrapolate from the first half to the second half of the seventies we shall be worse off once more in this decade – I shall say a little more about this later on.

Secondly: The West German economy is facing a period of increasingly in-

1. K.-W. Schatz, *Wachstum und Strukturwandel der westdeutschen Wirtschaft im internationalen Verbund – Analysen und Prognosen*, Kieler Studie, Nr. 128 (Tübingen 1974), p. 182.

tensive structural change. It seems to be a law of nature that growth requires change of proportions. This applies to human beings, animals, organizations, architectural structures as well as to firms and national economies. The change in structure which goes with economic growth is revealed when you order the national economies of the world according to their per capita income. Passing from the least developed to the most developed countries you find that the share of the primary sector is becoming smaller and that the secondary sector, comprising largely manufacturing industries, grows more than proportionately. This holds until you reach some of the most developed countries. From a certain point onwards, the secondary sector starts to decline in its share, but may still grow absolutely, while the tertiary sector (and here it is not the traditional but the modern tertiary sector) grows more than proportionately. The West German economy has by now reached the stage of the relative decline of the secondary sector. This shift of emphasis from manufacturing to the service sector is likely to go along with a decline in investment productivity. This has little or nothing to do with the productivity of those service industries which are under the pressure of competition.

It is rather the public sector (including public transport and government administration as well as education and even universities) which makes this expectation plausible. The shift in the structure of investment and growth from the competitive secondary sector to the sheltered service sector is being accentuated in West Germany as a result of a structural deformation; for compared with other countries the West German economy, in view of its income level, has too large a secondary sector.[2] This anomaly may have two causes.

One explanation is based on geography and is of little relevance here: West Germany occupies a central position in Western Europe from which industry benefits in the first place, and it is not as attractive a tourist country as, say, Switzerland or Austria.

The second explanation has to do with the faults of the Bretton Woods System. In the sixties Germany was an exporter of stability, and some of the neighbouring countries liked that. The Bretton Woods System had the characteristic of being dominated by the U.S. and of being based on a Dollar standard. While the U.S. fought a luckless war in Indochina, other countries, notably Ger-

2. G. Fels, K.-W. Schatz, F. Wolter, »Der Zusammenhang zwischen Produktionsstruktur und Entwicklungsniveau. Versuch einer Strukturprognose für die westdeutsche Wirtschaft«, *Weltwirtschaftliches Archiv,* 106(1971): 240–278; G. Fels, K.-W. Schatz, »Sektorale Entwicklung und Wachstumsaussichten der westdeutschen Wirtschaft bis 1980«, *Die Weltwirtschaft,* 1/1974, pp. 52–82.

many, accumulated an export surplus by supplying goods to the U.S. and those countries which had received the dollars that the Fed was producing at an accelerating pace. The result was an overgrowth of the manufacturing sector. To put it differently: an undervalued currency, which is what you have when you export stability under fixed exchange rates, is equivalent to an export subsidy and a protectionist measure in favour of all import-competing activities. The DM has been undervalued in this sense until the beginning of the seventies. Now floating has initiated an adjustment process. At first, adjustment was somewhat delayed by the world superboom of 1973, when German exporters of manufactures could maintain their position in world markets in spite of very high prices. They could cash in on some non-pecuniary advantages they had to offer: high product reliability or the myth of it, and quick delivery periods due to relatively weak domestic demand. But in the meantime, the world recession has changed the picture drastically. German exports are down and German manufacturing industries suffer from the strains of an accelerated adjustment process.

Thirdly, I suspect that investment productivity will further decline because West German industry is fairly close to what I may call its productivity potential. In the fifties and even in the sixties German firms could import from the U.S. and other more advanced countries a large arsenal of well-tested technology. The multinational corporation and what has been called the »American Challenge« have greatly helped to close whatever technological or managerial gap may have existed at the beginning. While the Japanese have imitated, imported, adapted and developed foreign technology in an attempt to overtake the Europeans and even the Americans in important lines of production the German manufacturing firms seem to have been concentrating on good labour-management relations and on coping with the problems resulting from a very marked profit squeeze since 1970. Instead of producing new technologies and instead of exporting capital and technology, the West German economy has far too long been misled by a wrong exchange rate to import technology as well as labour and capital. The proof is a strongly negative payments balance for patent fees and royalties. And this is so although the West German economy has a factor endowment which should give her a comparative advantage in lines of production requiring relatively much human capital and research input.

3. Let me now move from saving, investment and the capital market to the labour market. Here my proposition is as follows.

The West German economy which in the second half of the sixties could realistically aim at an unemployment rate of one percent is most likely to have a much higher average rate over the next business cycle. I expect a figure of not much less than 3 percent. Here are my arguments:

Firstly: In the recent downswing many firms have learnt that for social reasons it is very difficult to dismiss workers who cannot be gainfully employed; in many cases they had to give what is being called a golden handshake. After this experience they will hesitate to hire many more people during the next upswing. Instead, they will try to cope with additional demand by working overtime. And I see no signs of resistance from those workers who have been happy to stay in work. As a general conclusion I would say that the trend towards syndicalism is likely to increase the income difference between those who are employed and those who had the bad luck of being fired. The situation will probably not become as bad as in Yugoslavia where workers self-administration has resulted in a maximization of profits per head of those who are employed, instead of maximizing the rate of profit per unit of capital. But if we really moved towards the Yugoslavian model via co-determination we would be hit even harder than Yugoslavia herself; for there would not be a capitalist country to which we could export our surplus labour.

Secondly: I expect a higher normal or natural rate of unemployment of an increasing pressure of women to participate in the labour force.

Thirdly: We may get more youth unemployment. On the one hand, there are still the consequences of the post-war baby boom although this is subsiding. On the other hand, the government is trying to raise the requirements which firms have to meet when they embark on youth training. The consequence is that as long as firms are not paid for this they will refrain from training a sufficient number of apprentices for the simple reason that many of them will not be able to afford employing people at a cost which exceeds their short-run marginal product.

Fourthly: Trade unions, in their well-meant endeavour to help the poorest, have pressed for lump-sum wage increases independent of previous wages and qualifications. This has made unskilled workers relatively expensive as compared to skilled workers. In a period of wage drift that need not matter very much. But since (for the reasons mentioned) there is little scope for an excess demand for labour, the relatively high wages for unskilled workers will not be without consequences. As unskilled workers can easily be replaced by machines and as high wages in a capital-rich country would lead one to expect a substitution of capital for labour. I am sad to foresee a relatively large amount of unskilled unemployed. You may call it technological unemployment induced by a well-meant distortion of the vertical wage structure.

Fifthly: In the last six years we had in Western Germany a quantitative explosion of the educational system, particularly on the academic level. In the long run demand will certainly adjust to this new supply although I am not very confident with regard to teachers and sociologists. But over the next four to five years the unemployment rate will be inflated by a sizeable amount of what some people call the academic proletariat.

Sixthly: There will be more frictional unemployment than we had in the past. The reason is that I expect for the West German economy a different type of economic growth: less growth in width and breadth, more qualitative growth and more growth with structural change. Part of the structural change will be conditioned by growth itself. The other part has to do with the increasing pressure from developing countries which rightly try to invade our markets and which will, I suppose, successfully outcompete a number of traditional labour-intensive industries. These sensitive industries are, for example, wood manufacturing, the electrical industry, the production of toys, conventional sports equipment and musical instruments, the leather industry, the production of shoes and the textile and clothing industry. As a result of more structural change we shall have more dismissals and more hiring than in the past. In the past this structural change was delayed because of the influx of foreign workers, and we could import them, where they were needed. Instead of using selective imports of labour we have to widen bottlenecks by shifting the domestic labour force.

4. I now come to the cyclical problems of the West German economy.

Part of the decline in profits and in investment and growth may be a cyclical phenomenon. A somewhat streamlined story of German business cycles would read like this. We started after a short adjustment period following the currency reform of 1948 with a long upswing which had its peak in terms of capacity utilization in the Corean boom of 1951. This was definitely a maxiboom. What followed after this was a minirecession in 1954 and a miniboom in 1955. The subsequent recession had its trough in 1958. It was a maxirecession, again measured in terms of capacity utilization. Maxiboom-Minirecession-Miniboom-Maxirecession: this is the pattern which dominated the German business cycle also in the sixties and seventies. These are the details: A long upswing after the maxirecession of 1958 culminated in the maxiboom of 1960/61, which was followed by the minirecession of 1962 and the miniboom of 1965. The maxirecession which had to come according to my theory, duly started in 1966 and had its trough in the spring of 1967. It coincided with the downfall of the Erhard government, and with the appearance of Karl Schiller on the political scene. As the "law" of the German trade cycle predicts, we had a long upswing which peaked in the superboom of 1970 and which was followed by a minirecession in 1971. The subsequent boom was a miniboom in 1973 and it was bound to lead into a maxirecession which is what we have presently in 1975. You may say that all this is said with hindsight, but you can trust me when I say that I predicted the present maxirecession on the basis of this rule more than 18 months ago in a series of speeches. If the rule holds also for the future we should expect a long upswing which may last two and a half to three years.

The experience that deep recessions are followed by long upswings should make us optimistic for the next two or three years provided that the theory behind it is correct. This theory is based on the argument that the unemployment which is so severe in a deep recession as the 4,5 percent prevailing now in Germany cannot fail to have its impact on wage behaviour. In the 1967 recession unions were so intimidated that they did not catch up with productivity and price increases until late 1969 after a series of wild-cat strikes in September had threatened to upset the institutional framework of the labour market. History may not repeat itself, and the fact that the new upswing which most people expected in the spring of 1975 has not yet shown up by the beginning of autumn may indicate that the cyclical pattern has changed. But what is different now and what has delayed the upswing so far is that we cannot rely on export-led growth. Trade unions have reacted to the unemployment as reasonably as in the past, and if the upswing should be delayed until the spring of 1976 the next wage round which is due for January 1976 will bring little more than a compensation for the expected inflation rate.

In an upswing after a maxirecession there is usually a profit explosion. It is due to a long wage lag in the face of a jump in productivity. Compared to a minirecession a maxirecession does exert much more pressure to reorganize and to restructure production and to reduce costs per unit of output by rationalization measures. To some extent, such productivity increases are merely potential ones, as long as output is stagnating. But when real demand starts to increase, this potential results in actual productivity increases. To put it differently: the productivity increases which accelerate during the recession translate themselves partly into "unemployment on the job". The firms tolerate this unemployment on the job and do not dismiss enough workers if and because they anticipate the revival and because they know how important it is for their survival to keep a fixed stock of labour in terms of research teams and well functioning operating units.

The next point I want to make relates to the cyclical development of the last four or five years. We had a minirecession in 1971 in West Germany and in many other countries, and you will remember that in August 1971 Nixon made a spectacular effort to raise output and employment by combining an expansionary monetary-fiscal policy with price and wage controls. In Germany the recession was mild in terms of output and employment but quite severe in terms of business expectations which had been shocked by the appreciation of the D-Mark under floating since May 1971.

As a reaction to the world recession of 1971 the six most important countries of the Western world resorted to monetary expansion. Money supply in these countries – U.S., Germany, France, Japan, Italy and the UK – increased from an annual rate of 9 percent in the first quarter of 1972 to an annual rate of 18 percent in the last quarter of 1972. Of course, we were back on the dollar standard after the Smithsonian agreement and were forced to accept the dollars which the U.S. produced so abundantly, partly for the re-election of Mr. Nixon. With a time lag of not more than two quarters the quantity reactions could be observed in terms of an upswing: In the last quarter of 1972 and in the first quarter of 1973 the rates of growth of GNP jumped to almost 10 percent in real terms and on an annual basis in the six countries mentioned. As there had been no deep recession in 1971 there was not so much unused capacity to begin with, and capacity limits were reached fairly soon in 1973. The quantity effects, therefore, quickly translated themselves into price effects. Consumer prices in the six countries rose by 10 percent in late 1973 and by an annual rate of more than 15 percent in the first quarter of 1974. This inflation wave induced monetary authorities to put their feet on the brakes, and in the third quarter of 1973 they reduced the growth of money supply, which had been 12 percent in the quarter before to not more than 5 percent. Again it took only two quarters for the quantity reaction to follow in the same direction:

In the first quarter of 1974 real GNP of the six countries decreased by an annual rate of six percent.

The Federal Republic has suffered by, and contributed to, this acceleration and deceleration process. The maximum increase in the money supply actually amounted to an annual rate of 18 percent in the third quarter of 1972 which was about the time of the general elections.
A year later – in the third quarter of 1973 – the growth rate of the money supply became negative at an annual rate of not less than 10 percent. How could the economy remain on an even keel in these circumstances?

The story would not be complete without mentioning oil. The oil price explosion added to the recession by capturing half of the productivity increase of 4 percent which might have been achieved in 1974 if wage bargains had been oriented at full employment. About 2 percent of producable output had to go to the oil-producing countries and were not available for domestic distribution. The distributable productivity increase that was competible with full-employment, therefore fell to two percent. The wage round produced a general increase in the nominal wage level by about 12 percent. Whoever promised full employment and job security under these conditions must have meant an inflation rate of 10 percent for 1974 in Germany, 10 percent to reduce 12 percent nominal to two percent real. The Bundesbank through its monetary policy permitted only 7 percent inflation. The difference of 3 percent was an unintended increase in real wages, but only for those who remained employed. The others lost their jobs because firms were unable to increase prices to the extent that would have been necessary to maintain minimum profits. A number of firms broke down, others had to release workers just in order to survive. Thus the German economy moved into a home-made recession with severe repercussions on its trading partners.

To some extent, this recession could have been avoided, if wage bargains, instead of anticipating a 10 percent inflation rate, had provided for an ex-post compensation of purchasing-power losses, e.g. by means of index clauses. I can say this without resorting to hindsight knowledge because I recommend it at the time; however, my proposal was not accepted.

The stabilization crisis which we have is characterized by a near collapse of the building industry. This could have been prevented as well if during the period of increasing inflation the Government had issued index linked bonds as an inflation-proof substitute for those houses and appartments which were demanded for the sole purpose of providing a hedge against inflation. These houses and appartments, which I used to call "concrete gold" can be found everywhere in the country. It will take a long time until this excess supply has been absorbed in the course of the next upswing. Thus the building industry will be among the lagging sectors for the next two or three years to come.

How do we get out of the current recession? A first lesson from the collision between the Bundesbank and the Trade Unions has been drawn by the Bundesbank. It has announced for the first time in German monetary history a target rate for the increase in central bank money in 1975. This rate is 8 percent. The announcement had an impact on wage demands and wage settlements for the present year. Actual wages increases were about 6 percent which is practically equal to the rate of inflation which we are having now. As a matter of fact we have a pause in real wage increases for large segments of the labour force. This is a good starting point for a new upswing.

The upswing was announced by the Government before the elections in North-Rhine-Westphalia in May, but so far it failed to come about. The explanation is the sharp decline in exports. GNP in the first quarter of 1975 declined by an annual rate of 4.6 percent of which no less than 4 percentage points are accounted for by the decline in exports. At the present time the economy seems to have reached the bottom of capacity utilization with a gap between actual and potential output of about 9 percent. If potential output were to grow at a rate of 3 percent we could well have an upswing of three years with a growth rate of 6 percent each year. But there are widespread doubts about whether real demand will speed up that much.

The trouble with real demand are inflationary expectations. They are clearly visible in the capital market where people are reluctant to lend at an 8 percent interest rate for more than 4 or 5 years. This failure of the long-term interest rate to fall enough to induce new investment projects has something to do with the expectation that the government will be a heavy borrower in the autumn of 1975 and in 1976. Thus the present efforts to cut current government expenditure are welcomed by private borrowers in the capital market, but in the short-run, they have, of course, a negative influence on aggregate demand.

What appears necessary for fighting inflationary expectations and unemployment at the same time is a pause in real wage incomes. I would recommend it for the first six or nine months of 1976 and I would suggest that it is implemented by means of an index clause. This should increase profits to recovery levels. Some additional quantity signals should then be sufficient to get the upswing started. The two industries which are having their trade fairs – electronics and automobiles – seem to be on the verge of optimism. I am on record with the prediction that the upswing is likely to start before next spring. After all we have general elections in both the US and Germany in the autumn of 1976. I am confident that both Arthur Burns and Karl Klasen are as sensitive in this respect as their counterparts on the political scene.

The German Sachverständigenrat has hypothetically suggested that the German economy may be on a six percent growth path in 1976. Contrary to public opinion I do not consider this as overoptimistic. In fact we could attain such an increase in output without employing any of those who are presently unemployed. The calculation is fairly simple. We are going to have four to five more working days in 1976. This alone gives 1.5 to 2 percent increase in output for the whole year. And a productivity increase of 4 to 4.5 percent is a very modest estimate for an upswing after two years of recession. Let me put it differently: if the unemployment rate in 1976 would fall substantially below the present rate of 4.5 percent I would be surprised, and I would be prepared to call it a miracle.

With this flight into metaphysics I must conclude since I have already taken up too much of your time.