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Why More Stable Prices than Abroad?

by Günter Großer, Hamburg *

In many of the western industrialized countries the rate of inflation — high as it was — almost doubled between 1973 and 1974 whilst in the Federal Republic it did not escalate any further, the oil price explosion notwithstanding. Are the basic economic and social conditions in the Federal Republic more conducive to stability than elsewhere?

The 7 p.c. increase in consumer prices during 1974 has given rise to diametrically opposite assessments in the discussion about the success or failure of the anti-inflation policy in the Federal Republic. On the one side it is pointed out that it was the highest rate of increase since the bout of inflation in 1951 which followed the outbreak of the Korean war. On the other side it is observed that the cost of living has gone up only half as much as in the average of the other western industrialized countries.

Price Stability Is Relative

To take a realistic view, one must remember that price stability, although one of the basic economic objectives, at no time since the war meant firmly fixed price levels. The last time such fixity was achieved in the Federal Republic — in terms of the consumer price index — was in 1954. Basically it has always been a question of keeping the price rises down to a level within what were supposed to be socially acceptable limits, and in the seventies these limits were found to be far more flexible than had been assumed. It helped no doubt that people had got used to seeing the inflation rates in other countries to be regularly higher than in the Federal Republic.

Between the mid-fifties and the end of the sixties, that is the part of the post-war period in which the world economy had relatively few problems to worry about, the consumer prices on average advanced by little more than 2 p.c. per annum in the Federal Republic. The USA alone was showing a like measure of stability at that time. In most of the other industrialized countries prices rose by 3–4 p.c. a year and in "record years" occasionally by 5–7 p.c. It was against this background that a temporary inflation rate of 4.5 p.c. in 1966 developed into one of the main factors for the domestic crisis of confidence which led to the resignation of the then Federal Chancellor, Erhard.

In 1969 began in the western industrialized countries that phase of continually escalating inflation

which led last year to price rises transcending even those of 1951. At times it looked as if the Federal Republic could no longer play the role of an "island of relative stability" in an inflationary sea. Having risen steadily since 1968, its inflation rate in the early seventies drew level with the international average, and the picture did not look much better if the comparison was confined to the West European economies. In 1973, when prices abroad shot ahead again, the Federal Republic once more managed to set its own pace. Not until 1974 however did its relative price stability give it such a head start that it seemed to be a basic characteristic as in the fifties and sixties — and this although the Federal Republic alone among the industrialized countries was doing without direct price controls (cf. Table 1).

Table 1
Annual Increase in Consumer Prices
(in p.c.)

	1970	1971	1972	1973	1974 ^a
Austria	4.4	4.7	6.3	7.6	9.5
Belgium	3.9	4.3	5.5	7.0	12.7
Federal Republic of Germany	3.4	5.3	5.5	6.9	7.0
France	5.2	5.5	5.9	7.3	13.7
Great Britain	6.4	9.4	7.1	9.2	16.0
Italy	5.0	4.8	5.7	10.8	19.0
Japan	7.7	6.1	4.5	11.7	23.0
Netherlands	4.4	7.6	7.8	8.0	9.5
Sweden	7.0	7.4	6.0	6.7	10.0
Switzerland	3.6	6.6	6.7	8.7	9.8
USA	5.9	4.3	3.3	6.2	11.0
Industrialized Countries total ^b	5.7	5.2	4.6	7.7	14.0
West European Industrialized Countries total ^b	4.7	6.0	6.1	7.9	14.0

^a Partly estimated. — ^b Enumerated countries, weighted according to national product and exchange rates of 1973.

Sources: OECD, national statistics, own estimates.

If comparing the price deflators for GNP which leave imports out of account so that the domestic contribution to total supplies only is measured, it

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becomes quite clear that the rate of inflation in the Federal Republic was at certain times in 1970 and 1971 above the average of other industrialized countries. Later however it was kept far below it. Measured against the gross national product, the German inflation rate subsided from not quite 8 p.c. in 1971 to 6–6½ p.c. in later years.

So the trend of prices in the early seventies shows that it is by no means a matter of course for the Federal Republic to have greater price stability than other industrialized countries. Since the Federal Republic has however in the past two years managed to find its way comfortably back to the lowest place on the inflation scale, it should be asked why this happened. Are the basic economic and social conditions in the Federal Republic so much more conducive to stability than elsewhere? What was the part of economic policy in this? That no precise answer can be given to these questions emerges plainly from even a general discussion of the causes of inflation. At best one can examine certain aspects.

The development of the major cost factor may be chosen as a starting point: In the seventies wage costs per unit of production rose in all leading industrialized countries except the USA at a faster rate than before, partly because the increase in productivity slackened, but in the main because the upswing of wages gathered strength. The Federal Republic alone was more or less exempt from the soaring of wage costs in the past year. To judge by the relative movement of wage costs and price deflator for GNP, that does not mean that the "redistribution impact" in favour of the wage-earner was any less marked. The facts indicate that the scope for passing on higher wage costs in higher prices has greatly narrowed in the Federal Republic (cf. Table 2).

Impact of Exchange Rate Variations

The second cost factor to feel an "explosion" in 1973/74 were the import prices. A major part in it

had the huge price increases for crude oil, but also for other raw materials and subsequently for semi-finished and finished goods. The average import prices in the Federal Republic which had actually been declining for several years rose in 1973 by 5 p.c. and in 1974 by another 26 p.c. But then import prices in France, Great Britain and the USA advanced by about 50 p.c. (in local currency) and in Italy and Japan by about 75 p.c. Divergencies of this magnitude no doubt owe something to differences in the composition of the imports. But changes in the currency exchange rates have also been of considerable influence: in 1974 the European economies mentioned and Japan saw their currencies lose between 4 and 10 p.c. of their value on an annual average whilst the D-Mark was upvalued by 6 p.c.¹ Over the whole period since the autumn of 1969 the D-Mark increased in value by approximately 40 p.c. whilst the external value of the currencies of the other countries with the exception of Japan declined quite noticeably. Here is clear evidence of the protection which changing parities gave to the Federal Republic against the upsurge of prices abroad.

The D-Mark has gained so greatly in the last six years firstly because of the substantial cost advantage which the Federal Republic had manifestly obtained by the end of the sixties, to some extent as a result of the German recession of 1966/67. That it increased its share of the world market still further although its prices had in consequence of the revaluation risen rather more than had those of foreign products on average however suggests that there have been other than price factors at work as well. Among these is the advantageous mix of the German export goods assortment and certainly also its reliability as a supplier which has suffered much less from labour disputes than that of other countries. Added to this, the slackening of domestic demand in the last two years,

¹ As against the 16 other currencies officially quoted on the Frankfurt bourse.

Table 2
Prices and Costs in Major Industrialized Countries
(Annual Increase in p.c.)

	Consumer Prices			Price Deflator for GNP			Wage Costs per Unit of Production		
	1966-69	1970-73	1974 ^a	1966-69	1970-73	1974 ^a	1966-69	1970-73	1974 ^a
Federal Republic of Germany	2.2	5.3	7.0	2.5	6.7	6.5	2.3	8.8	9.0
France	4.1	6.0	13.7	4.6	5.9	12.0	4.6	7.0	14.0
Great Britain	4.1	8.0	16.0	4.1	9.1	13.0	3.7	8.7	16.0
Italy	2.4	6.6	19.0	2.7	7.4	16.0	2.7	11.5	18.0
Japan	4.9	7.5	23.0	4.2	7.1	26.0	3.1	9.9	27.0
USA	3.8	4.9	11.0	3.6	4.7	10.2	5.0	4.7	11.0

^a Partly estimated. Sources: OECD, DIW, national statistics, own estimates.

which was brought about earlier than in other countries by a restrictive economic policy, was a point in the German manufacturers' favour in so far as it improved their international competitive strength in regard to delivery terms.

Floating Favours a Policy of Stability

In the final analysis it is the economic policy which is the key to an understanding of the causes of variations in the rates of inflation. Individual countries had little chance of going their own way as long as the system of fixed exchange rates limited their freedom. It was under this system that the inflation rate in the Federal Republic in the early seventies fell into line with the international inflation. How greatly its freedom of action was hampered is shown by the extremely large inflows of foreign currencies at the time. These were the most important counter-currents of the big US balance of payments deficits which gave a critical impetus to the world-wide inflation. After the change-over to floating against the dollar in the spring of 1973 the economic authorities in the Federal Republic made resolute use of their enhanced autonomy for the fight against the inflation. Soon afterwards other countries also resorted to more restrictive monetary policies, but as comprehensive programmes as had been adopted in the Federal Republic followed only much later — in France and Italy in the early summer of 1974. This head start of the Federal Republic in the fight against inflation proved of crucial importance when the oil price explosion burst in the autumn of 1974. Apart from giving an immediate, calculable hoist to the price level in the industrialized countries, the consequent shift in foreign trade price relations and lowering of domestic real incomes acted as a stimulus on the struggle about the distribution of the national product in the industrialized countries. Prices and wages now propelled each other fast to new heights. In no other country however did this stimulus encounter as effective a constrictive environment as in the Federal Republic. The result was that the impulses on costs and prices from the higher oil prices were kept to a minimum.

It must however be asked in this context whether the response of prices and wages to cyclical changes — of moderate proportions though it may be in itself — is not markedly greater in the Federal Republic than it is in other countries. This may be the case because the competition in the goods markets — encouraged by a comparatively liberal import policy — is perhaps more severe. Or it may be that the organisation of the labour force in vertical trade unions avoids the demarcation and confrontation troubles which are caused in other countries by the rivalry of different crafts unions or unions with different political aims. Of greater importance however is probably that the determination of the economic authorities to persevere in a restrictive course in order to fight inflation evidently evokes more appreciation than in other countries.

Limits of Economic Autonomy

The scope for free economic action which was provided by the change-over to currency floating was also of decisive importance in this context because it made it possible to lag so far behind the pace of international inflation. One must not however overrate the scope available for a restrictive policy. Differences in the level of economic activity between individual countries will — in the short term at least — have a stronger impact on the course of the foreign trade and the foreign trade balances than the shift in currency parities. That fact has been underlined by the leap which the German trade surplus took in the past year. Even though this does not cause any international liquidity problems while the currencies are floating, the changes in trade balances involve changes in employment levels. As a result, a government more intent on stability than others is exposed to growing pressure from other governments which want it to depart from its restrictive course, the more so if the economic world situation deteriorates. There is evidence here of the narrow limits which will in fact always restrict economic autonomy — that is, the possibility of pursuing a combination of economic objectives of one's own choice — in a closely integrated global economy.



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