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## From Shock Therapy to Gradualism

### Anti-Inflationary Policy in Germany from 1973 to 1979

by Armin Gutowski, Hans-Hagen Härtel, Hans-Eckart Scharrer, Hamburg\*

**A whole range of economic solutions have been proposed in recent years in an endeavour to combat rising inflation. Of these, the discussion on a policy of gradualism vis-à-vis shock therapy has given rise to considerable controversy. In the light of this controversy the following article analyzes the German experience with anti-inflationary policy between 1973 and 1979 and draws some important conclusions.**

The period 1973-1979 of German anti-inflationary policy can be broadly divided into two stages. In the first stage, from the spring of 1973 to the end of 1974, economic policy showed the attributes of a shock therapy, whereas in the second stage, from 1975 to the beginning of 1979, a gradualist approach was taken. As will be shown in the following analysis the German experience demonstrates

- that the alternative "shock therapy versus gradualism" cannot be discussed without taking into account the causes of inflation and previous economic policy;
- that the authorities do not have full control as to whether any given set of policy measures will produce gradualist or shock effects; additional external and domestic economic factors contribute to determining the outcome;
- that the success and the costs of a shock therapy depend on the actual social and economic situation;
- that monetary policy alone cannot be held responsible for creating and fighting inflation and inflationary expectations; external variables, fiscal policy and wage policy also play a certain role.

#### The Situation in Early 1973

In the spring of 1973 German policymakers were confronted with the problem that the acceleration of the inflationary process which had started as a cyclical phenomenon had changed to become a trend phenomenon. In the course of the strongest boom of the post-war period, the rate of inflation, measured by the index of consumer prices, had increased from 1 % in 1967 to a record 6 % in fall 1971. The deceleration

following the boom was but short and mild and only resulted in bringing the inflation rate down to 5 %. As soon as a new upswing started by mid-1972 the inflation rate began to accelerate anew. In spring 1973 the 7 % mark was reached.

The stiffening of inflation, which led to an ever-increasing loss of confidence, had three main causes:

- Economic policy had failed to safeguard the stabilisation success achieved in the recession of 1966/67 by timely and sufficient revaluations of the D-Mark. To keep the exchange rate from rising the Bundesbank had to buy dollars pouring into Germany in large speculative waves and to convert them into D-Mark. In doing so, it financed the inflationary boom.
- The state budgets were placed at the disposal of the so-called *Reformpolitik* or policy of reforms which aimed at widening the public sector. Yet, politicians were unable to convince people of the necessity of higher taxes to pay for the "benefits". Under these conditions, implementation of a neutral or even restrictive fiscal policy turned out to be even less feasible than under more "normal" conditions.
- The trade unions were pursuing a more aggressive wage policy aiming at a permanently higher share of wages in national income. By anticipating future price increases in their wage demands they successfully prevented a downward correction of the high level of real wages via inflation. The employers were prepared to comply with the unions' demands and to grant excessive wage increases, apparently led by the hope of eventually being able to fully shift higher costs on to their customers via prices.

Over quite a long period, inflation was only imperfectly anticipated by economic agents and thus

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fuelled economic activity. The expansionary impulses from the export boom (which in itself was supported by the exchange rate) and from budgetary policy were stronger than the contractive effects of rising real wages. Furthermore, the Government felt compelled to adjust social security payments more quickly to inflation and also to expand their range. As a consequence, the built-in restrictive effect of the social security surpluses was eliminated. And finally, increases in interest rates lagged at first behind inflation; the decline in real interest rates stimulated the propensity to invest and gave rise to continued overheating of the building boom.

### **Risky Policy Choices**

The longer economic policy kept this process going, the more inflation-induced adjustment processes and a growing anticipation of inflation threatened to depress economic activity: price and cost increases would diminish international competitiveness; interest rates would adjust to inflation; the building boom would break down, not only owing to rising real interest rates, but also because of a rapidly increasing supply of new apartments; and with lessening demand expansion and a high cost level the propensity to invest would decline. Slower growth of capacity and slower increases in productivity would on the other hand render more difficult the containment of inflation so that in the end stagflation would be the bitter consequence.

Yet, as long as the Bundesbank was under the obligation to intervene in the foreign-exchange market an effective anti-inflationary policy was beyond reach. This constraint was removed in the spring of 1973 with the collapse of the Bretton-Woods-System. But at the time economic policy was faced with the dilemma that either further delay or a strong curb entails high risks. On the one hand the rapid acceleration of price increases had brought about a further loss of confidence. The typical process of an adaptation to inflation was right under way. Only few would still believe that economic policy would prevent a further rise of the inflation rate. More and more people adjusted their consumption and investment behaviour to the expected continuation of the inflationary process and assumed financial obligations which they were only able to fulfil with high price and income increases. On the other hand there was also the question whether the inflationary boom was not already coming to an end by itself owing to the widespread anticipation of inflation.

At first sight the situation seemed to call for a gradualist approach. From such a policy one might

have expected that, on the one hand, the decisions of economic agents would no longer be determined by the expectation of rising but of decelerating inflation rates; on the other hand, enterprises which up to then had relied upon their being able to pass on rising costs in higher prices would only be subjected to limited losses. However, conditions for success of a gradualist strategy were probably no longer existent in the spring of 1973:

□ Economic agents were expecting so strong an acceleration of inflation that a gradualist policy would indeed have had to allow for a further increase of inflation rates for some time to come. One may doubt whether confidence in a gradual slowing down of price increases could have been created at a time when inflation rates were actually still rising. Yet such confidence is an indispensable prerequisite for the success of a gradualist strategy.

□ Economic policy institutions and in particular the Bundesbank (which under the regime of fixed exchange rates had turned out to be a "paper-tiger" only) had first to restore their authority in order to create confidence in the success of a stabilisation strategy. They had to demonstrate that they were both able and willing to control monetary expansion.

□ In the past, the Government had assumed full responsibility for the maintenance of full employment. Therefore, parties to wage agreements had come to the illusion that whatever their wages settlements would be they would run no employment risk. Both employees and enterprises relied upon the Government to be willing and able to avoid a recession. They had to learn again that there is in fact a connection between real wages and employment which economic policy cannot permanently overplay. The best way for the authorities to destroy this illusion – an illusion which they had created themselves – was by demonstrating their preparedness to accept unemployment in case of a conflict with the bargaining agents.

### **Need for a Strong Medicine**

Thus there was reason to suspect that a gradualist policy would not solve the problems, and that by adopting such a strategy the situation might even become worse. On the other hand, a "salutary shock" appeared appropriate to convince economic agents that their problems could no longer be solved by inflation. In order to teach them the lesson economic policy had to prescribe strong medicine. This applied all the more since the simultaneous upswing of the

world economy was working as a countervailing force absorbing part of the shock. There was also the chance that the German economy would already be on the way to recovery once the inflationary boom would bring about stabilisation crises in foreign countries as well.

### Shock Policy without Shock Effects

After the world-wide adoption of floating exchange rates the Bundesbank made immediate use of its regained control over the money supply by substantially curbing the expansion of the monetary base. From the beginning of 1971 until early 1973 the monetary base increased at an annual rate of 12 %, i. e. 7-8 percentage points more than the growth of potential GNP. After the spring of 1973 the monetary base expanded only at an annual rate of 6 %, i. e. 2-3 percentage points above the growth of potential GNP (see Table 1). In addition the Government applied restrictive budgetary measures directed above all to affect the propensity to invest; among these, a 10 % tax on investment and a temporary suspension of degressive depreciation allowances for enterprises and in residential building were enacted. Finally, the economy was confronted with quite a substantial strengthening of the Deutsche Mark vis-à-vis foreign currencies.

The coordinated use of monetary and fiscal policy generated only limited effects. Domestic demand (private consumption, government expenditure and

investment) dropped by 2.5 % between the spring of 1973 and the spring of 1974. Despite that, real GNP continued to expand by 2 % as the enterprises were able to switch over to exports, notwithstanding the D-Mark appreciation. This was probably a major reason why economic policy had no quick success in the pursuit of its major goal, the turn-about of inflationary expectations. True, a further increase of the rate of inflation was avoided; it even slowed down to 6 % temporarily. But it was too late to change the expectations of wage earners, heated up by the inflation, with respect to massive wage increases. From the labour market there came no warning signals as employment remained high owing to the export drive.

The final blow to the chances of a quick success of stabilisation policy came from the oil price increase which had a forceful impact on the inflationary climate. Enterprises again became hopeful of being able to pass on rising costs in prices. Almost everybody believed that in 1974 the inflation rate would surpass the 10 % mark. In the forefront were the trade unions with their demands for wage increases of 15-18 %. As in the past, their fear of an erosion of the real wage position by inflation was greater than their realisation of the employment consequences of too high a wage level. Perhaps their assessment was influenced by the event that in the face of impendent economic slow-down the fiscal component of stabilisation policy had

**Table 1**  
**Indicators of Economic Policy 1967 - 1979**

	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
<b>Monetary policy</b>													
Measure:													
Monetary base <sup>1</sup>	5.5	9.0	11.0	6.0	11.5	13.5	8.0	5.5	9.5	9.0	9.5	12.0	6.5
Potential GNP <sup>1</sup>	3.5	3.5	4.0	4.5	4.5	4.0	4.0	3.0	2.5	2.5	2.5	3.0	3.0
Difference	2.0	5.5	7.0	1.5	7.0	9.0	4.0	2.5	7.0	6.5	7.0	9.0	3.5
Effects:													
GNP-price-deflator <sup>1</sup>	0.3	2.5	5.4	5.1	7.9	5.3	6.3	8.5	4.7	3.3	3.9	3.7	3.8
Gap between actual and potential GNP <sup>1</sup>	0.0	+5.0	+3.5	+0.5	-2.5	+0.5	-0.5	-5.0	-1.0	+1.5	0.0	+1.0	+1.5
<b>Fiscal policy</b>													
Budget balance <sup>2</sup>	-6.0	-4.2	+5.2	-5.0	-8.6	-13.8	-3.5	-18.4	-57.0	-41.2	-25.5	-33.1	-41.1
Full-employment budget balance <sup>2</sup>	+0.5	-1.5	+2.5	-9.5	-11.5	-14.5	-6.0	-13.0	-39.5	-29.5	-14.4	-27.0	-43.0
Ditto: Without inflationary excess tax revenue <sup>2</sup>	+1.0	-1.0	+1.0	-15.0	-18.5	-19.5	-10.5	-17.5	-43.5	-27.5	-15.4	-31.5	-47.5
<b>Income policy</b>													
Standard wages per employee <sup>1</sup>	1.8	4.8	8.1	14.6	9.3	8.8	10.7	12.8	7.3	6.1	6.7	5.5	4.7
Effective wages per employee <sup>1</sup>	2.6	7.7	12.4	14.3	9.9	10.2	13.2	11.8	6.3	7.3	6.5	5.5	6.5
Consumer prices <sup>1</sup>	1.0	2.0	1.9	4.0	5.7	6.2	7.3	6.4	5.5	3.7	3.5	2.4	5.3
Real wages <sup>1</sup> per employee	1.6	5.6	10.3	9.9	4.0	3.8	5.5	5.1	0.8	3.5	2.9	3.0	1.2

<sup>1</sup>Percentage changes from fourth quarter of the preceding year to fourth quarter of the current year.

<sup>2</sup>Billion D-Mark.

been given up and the state budgets had become expansionary once again.

### **Shock Effects Despite Expansionary Policy**

Under the impact of major labour disputes in the public sector the Government granted average wage increases of 13 % to public employees. The Bundesbank reacted to the challenge by reasserting its policy of limiting the expansion of central bank money supply<sup>1</sup> to an annual rate of 6 %. Investment demand continued to drop and with the start of the world-wide recession the export drive (which up to then had moderated the shock) came to an end so that the impact of the stabilisation crisis on employment made itself felt. As early as the end of 1974 the Government decided on new expenditures and in addition to that massive tax reductions were brought into force in 1975. The Bundesbank, too, relaxed its reins and announced that it would allow an expansion of the central bank money supply by 8 % in the course of 1975. Yet, production and employment continued to drop until mid-1975. Indeed, in the course of the stabilisation crisis 1.7 million people lost their jobs.

### **The Stage of Gradualism**

Even though inflation was still at a level of 6 % in spring 1975, and in spite of the fact that economic policy had already adopted an expansionary stance, stabilisation policy now showed signs of a quick and durable success. Under the impression of high and rising unemployment, wage increases of no more than 7 %, i. e. only half of the previous year's augmentation, were negotiated. The following process can best be described as a textbook-type gradualist process. Price advances, cost increases and inflationary expectations were simultaneously and gradually cut back. In fall 1978 the inflation rate reached its minimum of 2.2 %, in the spring of 1979 contractual wage settlements fell short of 5 %. What is not in line with conventional textbook wisdom is that all this happened with an expansionary monetary policy. Indeed, inflation was restrained, first, by recession and secondly by the strong appreciation of the D-Mark in the course of the dollar weakness.

At first sight it may appear strange that the period 1975-1978 in which inflation rates were going down has been labelled a stage of gradualism whereas the period 1973-1975, when inflation rates remained high has been characterized as a stage of shock therapy.

<sup>1</sup> The concept of "central bank money supply" ("Zentralbankgeldmenge") used by the Bundesbank as a target variable essentially corresponds to the monetary base.

However, this only demonstrates that the current rate of inflation and its change are irrelevant as regards the question of whether a given economic policy means a shock to the economy; what is important is rather, by how much the actual rate of inflation falls below the expected rate. The shock of 1973/1974 arose from the fact that the abrupt reduction of the rate of monetary expansion in conjunction with a restrictive fiscal policy prevented the enterprises from making their way in charging the two-digit price increases generally foreseen. On the other hand, in the gradualist period of 1975-1979 economic agents were indeed counting on a slowing down – and in any case not rising – inflation rate.

### **The Role of Budgetary Policy**

When assessing the contribution of budgetary policy to the restoration of price stability one has to keep in mind that it was the Government that created at least part of the problems it afterwards had to deal with. The public sector was a party in the distribution conflict which gave as much an impetus to inflation as it was itself fuelled by inflation. This distribution conflict took place on three different stages: between Government and citizens on the allocation of the national product among public and private goods; between employees and enterprises on their respective shares in national income; and between the various social groups on their equitable participation in the benefits and burdens of the Government's redistribution policy.

After 1969, budgetary policy was confronted with the task of increasing the public sector's share in GNP in accordance with the so-called "policy of reforms". Another stated policy objective was to distribute the tax burden in a more equitable way among taxpayers. The latter objective gave rise to a general anticipation of tax reductions, thus making it rather more difficult for the Government to impose the higher taxes required to finance the higher public sector share. The Government solved this conflict in a way detrimental to stability: instead of constraining the boom inflation was stimulated by an expansionary budgetary policy.

These expansionary impulses were not fully reflected in the budget deficits since the public sector, as a consequence of the favourable economic climate and rising inflation, benefited from excessive tax receipts. Computation of the budget surpluses or deficits in accordance with the concept of the "full employment budget", which eliminates the cyclically induced variations of the tax receipts, leads to a slight surplus for the period 1967-1969 and growing deficits of DM 10-15 bn for the years 1970-1972. If, in addition,

the computation of the tax receipts is based on a rate of price increase of 3 % instead of the actual inflation rates, the deficits for the latter period even rise to DM 15-20 bn (see Table 1).

Owing to the progressive tax system, tax receipts were rapidly increasing mainly at the expense of wage earners. However, this mechanism fuelled the distribution conflict between labour and management as the wage earners tried to make good for their disadvantage by demanding (and receiving) higher wage increases.

Owing to the high share of wages in the total cost of running the public sector, this sector was particularly hard hit. In the end, therefore, the state budget drew no profit from inflation. Yet, the Government came increasingly under pressure to refund the concealed tax "gains" caused by inflation. It was no wonder that it felt no longer strong enough to pursue a restrictive line of budgetary policy. On the contrary: it felt compelled to take an expansionary stance to counteract the employment risks caused by an ever-increasing wage level.

Finally, with inflation accelerating pension earners were increasingly put at a disadvantage. Under the German Social Security System pensions are adjusted to wage increases with a time lag of several years. However, social security contributions depend on current wages and their increases. In periods of accelerating inflation the system therefore runs surpluses. Strong political pressure induced the Government to speed up the adjustment of pension payments to inflation. Part of the surpluses were moreover used to enact new social security benefits.

#### Public Sector Deficit

At the end of the inflation-fuelled distribution struggle between Government and citizens, between wage earners and enterprises and between people of different income-groups the Government's hands were empty. The public sector had not been able to augment its activities more than in the years before 1969. Its expansion was fully made up by the higher cost of

public services. Yet the Government was forced to increase social benefits and to grant tax cuts to indemnify all those who pretended to be among the losers in the inflationary process. And finally the attempt to maintain the conditions for full employment by an expansionary fiscal policy brought about the opposite effect as the inflationary process concealed that employment risks were increasing more and more.

The Government's involvement in the distribution struggle gave rise to a permanent, structural public sector deficit. However, this has become apparent only since 1975 when it was no longer disguised by inflationary tax increases and when the tax cuts announced earlier came into force. At first this deficit was quite in line with cyclical needs as fiscal policy attempted to alleviate internal and external shocks and to counteract the cumulative reinforcement of the downturn. After having overcome the recession the Government was faced with the question whether the deficit (which had emerged not only at the level of state and local authorities but also at the Social Security System) could and should be maintained in the longer term. The decision was for a strategy of enforced budgetary consolidation which met with a surprisingly great success. However, another economic slow-down and strong political pressure from abroad were driving the Government back to an expansionary course of action.

#### Budgetary and Monetary Policy Links

No doubt, expansionary budgets have rendered the Bundesbank's stabilisation task more difficult. It must be borne in mind, however, that prior to the spring of 1973 the Bundesbank was unable to pursue an effective policy anyway given its obligation to intervene in the foreign exchange market.

The Bundesbank's policy change in 1973 was backed by fiscal policy. The transition to stronger fiscal expansion in 1974 was also harmonized with the monetary authorities. In its capacity as an employer, however, the public sector operated in a counterproductive way as it was the first to conclude

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excessive wage agreements which in turn spread all over the economy.

Since 1975 the central bank, for the first time in postwar history, was to conduct its monetary policy in a setting of high government deficits. To what degree the efficiency of monetary policy suffered from this fact cannot yet be established empirically. The Bundesbank being autonomous, both *de jure* and *de facto*, it need not pay attention to the credit needs of the Treasury. However, it cannot be ruled out that, as a consequence of the high public sector deficit, expansionary impulses of monetary policy have become less effective whereas restrictive measures hit private activity more strongly than before.

In summary, the following observations can be made. In 1975 the interest rate decline induced by an expansionary monetary policy was temporarily interrupted as high public sector deficits created the fear of inflation and as the Government had to gain experience with debt-management.<sup>2</sup>

Over the period of financial consolidation in 1976/77, expansionary monetary policy caused interest rates to decline strongly; this process came to an end when fiscal policy also switched over to an expansionary path. Yet, these limited experiences do not suffice to support empirically the crowding-out thesis: the interest rate decline can as well be explained by the cyclical downswing, and the rise of interest rates by the upswing.

<sup>2</sup> German Governments traditionally tend to finance budget deficits long-term.

In a purely national context it is at all events rather difficult to prove the existence of crowding-out effects. As a result of the integration of national financial markets into the international financial system, fluctuations of the public sector deficit may not only be compensated for by changes in domestic savings and investment but also by changes in the capital account with the rest of the world. In the latter case, changes of government deficits will not only bring about interest rate effects but exchange rate effects, too. The international character of the crowding-out problem is also demonstrated by the fact that increasing public-sector deficits are not only a German but a world-wide phenomenon.

### Economic Policy Conclusions

The German experience in the period from 1973 to 1979 demonstrates that it is almost impossible to reverse inflationary expectations without a shock once economic agents have lost their confidence in the authorities' willingness and ability to pursue an effective stabilisation policy. This is all the more true if the Government has been betrayed into making promises which cannot be fulfilled and which it first must get rid of (price stability with fixed exchange rates; full-employment with real wage increases clearly exceeding the rise of productivity; higher government expenditure with lower taxes, etc.).

It could also be shown that policymakers will not always know in advance whether their measures will cause a small or a heavy shock. For a given reduction

**Table 2**  
**Indicators of Economic Development 1967 - 1979**

	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
Development in real terms <sup>1</sup>													
GNP	-0.1	6.5	7.9	5.9	3.3	3.6	4.9	0.4	-1.8	5.3	2.8	3.6	4.5
Domestic demand	-1.8	6.0	8.7	7.4	3.9	3.7	2.9	-1.9	0.8	5.0	2.9	3.9	6.1
Private consumption	1.0	4.5	7.9	7.3	5.2	4.0	2.5	0.3	3.1	3.4	3.5	3.8	3.2
Private investment	-6.4	3.5	10.9	10.6	7.8	4.5	0.3	-13.2	-4.5	6.5	5.7	5.8	9.1
Public expenditure	1.0	1.3	5.9	6.0	5.0	3.3	4.3	4.9	3.1	1.1	-0.4	4.5	3.5
Net exports <sup>2</sup>	1.6	0.7	-0.5	-1.3	-0.5	-0.0	2.0	2.2	-2.5	0.5	0.1	-0.2	-1.3
Prices and costs <sup>1</sup>													
Consumer prices	1.6	1.6	1.9	3.3	5.2	5.6	7.0	7.0	6.0	4.3	3.8	2.7	4.1
Labour costs per unit	0.1	0.7	3.4	10.6	9.0	5.9	7.8	9.3	6.3	1.9	3.7	2.6	2.1
GNP-price-deflator	1.4	1.8	3.5	7.3	7.7	5.6	6.0	6.9	6.7	3.3	3.8	3.9	3.9
Difference	-1.3	-1.1	-0.1	+3.3	+1.3	+0.3	+1.8	+2.4	-0.4	-1.4	-0.0	-1.3	-1.8
Cumulative difference	-1.3	-2.4	-2.5	+0.8	+2.1	+2.4	+4.2	+6.6	+6.2	+4.8	+4.8	+3.9	+1.7
Employment (1962=100)	96.7	96.8	98.3	99.6	99.8	99.6	99.9	98.0	94.7	93.8	93.7	94.4	95.6
Unemployment rate in %	2.1	1.5	0.8	0.7	0.8	1.1	1.2	2.6	4.7	4.6	4.5	4.3	3.8

<sup>1</sup>Percentage change against the preceding year.

<sup>2</sup>Changes of net exports related to GNP of the preceding year.

of the rate of monetary expansion the impact of the shock depends upon whether the enterprises are able to switch over to foreign markets, whether the course of economic policy can be substantiated to the public, whether the public is in greater fear of inflation or of unemployment, and whether economic agents abroad are counting on the success of stabilisation policy and engage in transactions leading to an appreciation of the currency.

The success of anti-inflationary policy in Germany is mainly due to two factors:

Firstly to the *de jure* and *de facto* autonomy of the Bundesbank and to the preparedness of the Government as well as of private economic agents to submit to the monetary policy of the Bank as an "exogenous" variable.

And secondly to the willingness of trade unions to accept a downward correction of the real wages relative to profits after they had turned out to be too high. This policy was facilitated by productivity rising fast enough (3 % p. a.) to allow adjustment without an absolute decline in real wages. In this context it should be noted that in Germany trade unions have greater influence on the effective wage level than in many other countries. Wage increases agreed between unions and employer associations are usually granted to non-union members, too. There is also a tendency to come to quite similar agreements for all industries by following the pattern set by the "first" major settlement (until 1974 government employees, since then metal workers). It was mainly the negotiating parties' reaction to the anti-inflationary policy stance which led to a stabilisation crisis in 1974 but which since then has made stabilisation policy a success. In this context it should be mentioned that wage agreements have a duration of one year only, so that the parties are able to adjust rather quickly to changes in economic (policy) conditions.

### The Situation in 1979/80

It is interesting to compare the period of shock therapy of 1973 and 1974 with the period 1979/80 which was again characterized by an acceleration of inflation caused by a cyclical upswing and the second oil-price shock. Indeed, there are quite interesting parallels: whereas then the rate of inflation increased from 1 to 7 % in the course of a persistent boom, it rose this time from 2 to 6 % in the course of a relatively moderate upswing. The Bundesbank reacted then by restraining the expansion of central bank money supply from an annual rate of 12-13 % to a rate of 6 %,

and this time with a curb from 12 to 5-6 %. In both periods the previous acceleration of monetary expansion was caused by foreign exchange intervention. And in both cases the upswing was accompanied by an expansionary fiscal policy.

Yet there are important differences, too, which may explain why this time a shock was prevented. Interest rates rose more slowly than in the first period. They also did not climb to the same high level as then. Monetary restriction was not coupled with restrictive budgetary measures. Nor was it coupled with a strong appreciation of the D-Mark – on the contrary, the D-Mark even depreciated in real terms. The most important difference is, however, that this time the acceleration of price increases had relatively little influence on inflationary expectations. Hence, wage settlements in early 1980 provided for wage increases of "only" 7 % (as compared with 13 % in 1974), in view of an inflation rate of 6 %. If this time a widespread adaptation to inflation did not take place, this can be explained by the Bundesbank's timely turn to a path conducive to stability, and by the fact that economic agents did expect this considering previous experience. It can therefore be argued that in 1979/80 a shock therapy was not required. Besides, a given slowdown of the rate of monetary expansion was this time probably less harmful than before as the economic agents' ability and preparedness to adjust to the stance of monetary policy had improved in view of their painful experience with the stabilisation crisis of 1973/1974.<sup>3</sup>

Even if on the whole the "teaching effect" of the stabilisation crisis may be considered as being positive one should not overlook that not all of the problems were overcome which made the stabilisation crisis occur or which the crisis itself had created. In this connection one has first to think of the employment problem. The last upswing brought about a normal employment of physical production capacities but not of the labour force. The excessive level of real wages realised in the first half of the seventies has since been corrected though not enough to enable enterprises to offer jobs to all unemployed willing to work. Another problem is the high level of government debt which continued to increase during the recent upswing, narrowing the scope for future policy action in the event of recession. As long as these two problems remain acute the temptation to solve them by inflation will always reoccur.

<sup>3</sup> Also the announcement by the Bundesbank of quantitative targets for monetary expansion does help to clarify the Bank's intentions and to avoid misunderstandings such as happened at the turn of 1973/74.