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## The German Economy in 1982 and Beyond

by Dieter Wermuth, Frankfurt\*

**The Federal Republic of Germany is presently experiencing the deepest and longest recession in its history. The situation is characterised by high and rising unemployment figures, slowing growth, a steep increase in the number of bankruptcies in the business sector as well as by a rapidly rising public sector deficit. The key to any solution, Dr. Wermuth argues, is held by the German monetary authorities more than by anyone else.**

The forecasts of the season, differ as they may in some of the details, all come up with the same basic scenario. Invariably, some time during 1982 German GNP growth is to pick up again, with inflation and interest rates falling. The current account deficit, which had reached its record in the first quarter of 1981 (DM 9.8 billion or, annualized, DM 39.2 billion), keeps shrinking and even begins to move into surplus. In this environment, a healthy appreciation of the Mark on the exchange markets is next to unavoidable, unless the Polish crisis escalates seriously or dollar interest rates fail to return to "civilized" levels. These are the two most common caveats. As to the labor market, all forecasts agree that a further increase in the number of unemployed can not be avoided. The unemployment ratio may average somewhere between seven and eight percent. So far, the German public has accepted this likely outcome rather calmly. For a country which has been used to unemployment ratios of around one percent for most of its postwar history (through 1973), and to the number of vacancies outstripping the number of unemployed by five to one or better, this is surprising indeed; the more so since no quick remedy is discernible to anyone. High unemployment is here to stay. Given an unchanged institutional set-up, economic policies of the sort pursued since the middle of the last decade will not bring about anything resembling full employment. The generation of a strong and long lasting boom in real capital spending, which is certainly the sine-qua-non for this, is not easy to imagine.

The key to any solution is presently held by the German monetary authorities more than by anyone else. Before this argument is developed more fully, some remarks about the short-term outlook and the origins of today's crisis seem appropriate.

The Federal Republic is presently experiencing the deepest and longest economic recession in its short

history although one has to concede that actual economic distress of the kind experienced during the 1929/33 depression and in earlier recessions is almost non-existent. For a society which has been conditioned to expect ever rising levels in its standard of living it is a serious matter, though, if 1.6 million people are without a job, more than at any time since the early fifties when millions of refugees from the East tried to find a job in the West. At close to seven percent, seasonally adjusted, the unemployment ratio now approaches French, Italian and American figures. The number of unemployed has almost doubled since the spring of 1980. The high-point will not be reached before the summer of this year which means that on average 1.7 to 1.8 million people will be out of work during 1982. The heated discussion about genuine versus "fake" unemployment has subsided.

The bleak situation on the labor market is one aspect of the present crisis. Another is the slowing-down of growth of potential GNP. Its growth was around 5 % ten years ago but is presently only around 2 %. The possibilities for a substantial year-after-year increase in the material well-being of the society have diminished considerably.

The situation is also characterized by a steep increase in the number of bankruptcies in the business sector, as well as by a rapidly rising public sector deficit. Contrary to the beliefs of widely read economic commentators the deficit is more of a symptom rather than a cause of the recession.

### Origins of the Recession

The crisis began when the OPEC countries raised the oil prices drastically for the second time at the end of 1978. The industrial countries had just achieved some success in their fight against unemployment. The oil producers were neither willing nor immediately able to transform their receipts into purchases of goods and services from the industrialized world. This resulted in a deflationary effect very similar to a sudden increase in

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the level of savings or an increase in the value-added tax to reduce a government deficit. While all industrialized countries suffered equally from the loss of purchasing power following the oil price rise of 175 %, there existed for the Federal Republic a further difficulty. At that time, the Deutsche Mark was measurably overvalued, both in terms of costs and selling prices, and no matter which base period is used. German products had become less competitive in world markets. Since the middle of 1979 foreign orders to German industry had stagnated, and since early 1980 they actually declined. On the other hand, imports increased steadily through the spring of 1981. The overvaluation was the dubious result of long-standing and successful anti-inflation policies in Germany; the mark had become an international reserve currency; while in 1970 less than 2 % of currency reserves were held in DM, the share had risen to more than 10 % by the end of the decade. Capital imports supported the upward pressure on the currency, even in face of the rapid worsening of the current account.

Contrary to what had been hoped for at the time of their introduction flexible exchange rates do not just equalize inter-country cost and price differences, but tend to overshoot in both directions. There has been no stability of the so-called real effective exchange rate since the inception of the current international exchange rate system. A country which pursues relatively

restrictive domestic policies must obviously take into account that its currency is liable to become overvalued and its products uncompetitive. As a result of this, the country may experience a worsening of its employment situation – with a time lag of a year or two. The opposite scenario is just as likely: expansionary policies plus real undervaluation. Exchange rates also often react strongly and “irrationally” to non-economic events and expectations, such as wars in oil rich regions or a heating-up of East-West tensions. Rapid shifts in the composition of currency portfolios do the trick.

The deflationary effects of the latest oil price explosion and the overvaluation of the mark were considerably enhanced when the Bundesbank switched strategy and began actively to follow a restrictive monetary policy in the summer of 1979: consumer price inflation had begun to accelerate again from its 2.2 % annual rate in the second half of 1978 to 4.1 % in the first half of 1979. This was the result of the miniature boom of 1978 and 1979 and perhaps even more importantly, of the new wave of higher oil prices. At the time when the new monetary restraint began, there were 860,000 persons unemployed in Germany. In retrospect it seems as though the very early restraining of domestic demand in conjunction with the accompanying DM-appreciation had set the stage for today's employment problems. The economic recovery was over before it had earned its name.

### Competitive Positions

– indices<sup>1</sup> based on calculations in a common currency, 1970 = 100 –

	1977	'78	'79	'80	'81	'82	1977	'78	'79	'80	'81	'82
	relative unit labor costs in manufacturing						relative export prices of manufactures					
USA	67	63	64	65	74	76	90	86	87	86	99	101
Canada	102	88	85	85	88	91	83	76	76	79	84	85
Japan	141	162	138	122	130	120	106	118	108	102	107	102
France	100	99	103	107	107	111	100	99	99	99	97	99
Germany	113	118	120	120	110	107	115	116	114	108	101	99
Italy	94	92	93	93	94	98	95	93	96	103	97	99
United Kingdom	89	98	115	144	142	131	97	106	114	126	128	123
Belgium	110	107	105	100	96	96	97	98	102	101	96	96
Netherlands	112	110	109	101	90	88	100	98	98	99	91	90
Denmark	96	96	97	87	80	84	104	104	102	97	95	95
Norway	141	128	115	113	118	123	120	105	98	96	89	90
Sweden	120	107	102	98	99	91	113	107	107	109	110	106
Austria	130	127	122	121	117	117	110	108	107	103	95	94
Switzerland	124	146	138	123	119	127	115	133	127	122	116	119

<sup>1</sup> An increase in the index means a deterioration of the international competitive position.

## ECONOMIC TRENDS

The restrictive stance of German monetary policy led to a DM-euphoria which lasted through the summer of 1980. An overvaluation of a currency exerts a favorable impact on domestic inflation, but there is always the negative impact on international competitiveness. In 1979 and 1980, when the dollar exchange rate averaged DM 1.83 and 1.82, German wage levels suddenly exceeded those in the United States by more than 10 %, and by an even higher margin those of other, economically less advanced countries. Germany had become a less attractive place for business to invest and to produce, there was a wave of German direct investment abroad, and between 1978 and 1980, the current account worsened by no less than US \$ 25.6 billion.

An overvalued currency tempts a country to live beyond its means, i. e. to import more goods and services than it needs to sell to foreigners. It creates an illusion of wealth: one does not have to work as hard as before because one gets a sort of free lunch – for a while! The German tourists who went on a worldwide spending spree illustrated this point in a truly impressive way. Even the public sector felt little pressure to restrain the growth of its spending as might have been desirable from today's standpoint.

### DM-devaluation to the Rescue

The adjustment of the exchange rate has meanwhile corrected some of the unfavorable developments, although in a system of flexible exchange rates such a correction must be perceived to be of a rather

precarious nature. In spite of the Bundesbank's attempts to prevent or at least slow down the Mark's fall on the exchange markets, the "real" depreciation finally came to 10 to 25 % between the high and the low point, depending on the indicator for the "real" rate. Competitive disadvantages could thus be more than eliminated. The purchase of foreign goods and services has become sufficiently expensive to impress both tourists and importers. German exporters, meanwhile, have considerably fewer problems on world markets than in 1979 and 1980. Foreign orders to manufacturing were 25.6 % higher in the six months through December 1981 than one year ago.

The trade surplus reached a seasonally adjusted DM 12.3 billion in the fourth quarter of 1981, compared to a mere DM 0.5 billion in the first quarter. The current account, not surprisingly, also moved into surplus, even on a seasonally adjusted basis (DM 3 billion). Since foreign orders to German industry do not yet show signs of letting-up while the Mark appreciated relatively modestly since its low-point in August, one does not yet need to worry about the international competitiveness of German industry. It is good.

The almost breathtaking reversal of the foreign balances was not just a product of more favorable exchange rates but also of a very sluggish growth of domestic demand for almost two years now. With considerable spare capacity available it was not difficult to quickly transform export orders into actual shipments. The pent-up need for structural change in the German

### Current Balances (in US \$ billion)

	OPEC	OECD	LDCs without oil	USA	Germany	Japan	France	United Kingdom	Italy
1970	–	6.9	–	2.3	0.9	2.0	0.1	2.0	1.1
1971	–	9.9	–	–1.4	0.8	5.8	0.5	2.7	1.9
1972	–	8.3	–	–5.8	0.8	6.6	0.3	0.6	2.0
1973	6.6	10.1	–11.5	7.1	4.6	–0.1	–1.0	–2.4	–2.7
1974	67.8	–25.1	–37.1	4.9	10.3	–4.7	–6.2	–7.7	–8.0
1975	35.0	2.4	–46.5	18.3	4.0	–0.7	–0.2	–3.4	–0.8
1976	40.0	–17.3	–33.0	4.4	3.9	3.7	–5.7	–1.6	–2.8
1977	31.1	–24.8	–28.6	–14.1	4.1	10.9	–3.1	–0.1	2.5
1978	–1.5	9.8	–37.5	–14.1	9.2	16.5	3.3	1.8	6.2
1979	53.0	–30.7	–57.6	1.4	–5.3	–8.8	1.2	–1.8	5.5
1980	101.5	–72.7	–82.1	3.7	–16.4	–10.7	–7.4	7.5	–9.6
1981	55.0	–35.0	–97.5	5.0	–7.7	4.7	–7.7	12.1	–9.5
1982	35.0	–26.8	–100.0	2.0	5.0	17.0	–7.0	2.3	–5.0

Sources: World Bank, World Economic Outlook, p. 124 f; OECD, Economic Outlook, Dec. 1981, p. 54 and 57; Citibank, World Outlook, Dec. 1981, p. 3 and 22.

economy, which is a carry-over from the two oil price explosions and the long period when the Mark was overvalued, requires a shift of resources from the domestic sector and energy-inefficient activities and products to the foreign sector and toward more energy-efficiency. This task is tackled defensively in Germany and in most other industrialized countries, with the noticeable exception of Japan, by pushing back domestic demand on a broad scale rather than by aggressively investing in new facilities.

In contrast to the sixties, the favorable export performance so far has not led to a chain reaction of an inventory build-up, higher spending on plant and equipment, a vigorous expansion of private and public consumption and, finally, of imports. High real interest rates more than anything else have prevented this. As long as the return on financial assets remains as high – and safe! – as it presently is compared to the return on real assets business has little incentive to invest. In addition, firms can not be certain that the present exchange rate level will be maintained to assure competitiveness on foreign markets. Germany is in the midst of an export drive if ever there was one; and we know of no country where this has not resulted in a considerable currency appreciation. Under flexible exchange rates there can be no assurance that restrictive domestic policies will lead to competitive advantages internationally and thus to full employment. In this sense, the fixed-rate European Monetary System acts as a kind of life insurance.

Although, at the moment, the German economy is kept moving because exports are expanding rapidly, this is a very shaky foundation for a genuine and broadly-based recovery. It may quickly crumble if the Mark is revalued again in real terms, as – among other reasons – an increasing number of countries try to get rid of their employment problems via competitive devaluations, a policy which may become fashionable again, or if the world economy stumbles into a still deeper recession because inflation is not yet under control in most countries and thus provokes even more restrictive monetary policies. There is also the danger of protectionist trade policies when one country floods the others with its goods.

#### Improved Inflation Outlook

The Bundesbank sticks to its tight policies because it still perceives considerable inflationary risks in the economy. Without determined anti-inflation policies there would be a new DM-depreciation and another surge in import prices; the wage and price spiral would begin to rotate again, and nothing at all would have been

gained for employment and growth. Efforts of two and a half years would have been in vain! Central bank money which the Bundesbank has chosen as its target aggregate, was thus allowed to drop through the floor of its 4 to 7 % range in October 1981; it stayed at its low level for the remainder of the year. The same had happened in 1980.

How about the short-term inflation outlook? It is actually much more favorable than it was during the past three years. All three broad cost categories, wages, import costs and capital costs, show signs of rising less rapidly or of actually falling.

□ The 1982 wage settlements will end up between 4 and 4½ % which is about 6½ percentage points less than the average wage increase abroad (compare table below). Unit labor costs were 3.8 % higher than their year-ago level in the fourth quarter 1981, down from 7.6 % in the first quarter. A new turn of the recession screw would send unit labor costs up faster again, however, because productivity would suffer.

#### International Wage Increases

– hourly earnings in manufacturing, percentage changes –

	Share in German exports in 1980	Average 1969 to 1979	1980	1981	1982
USA	6.1	7.7	8.7	9	8 ¼
Japan <sup>1</sup>	1.1	14.1	8.1	6	7
France <sup>2</sup>	13.3	13.7	15.1	14 ½	16
United Kingdom <sup>3</sup>	6.5	14.9	17.8	12 ½	11 ¼
Italy <sup>2</sup>	8.5	20.2	22.5	22	18 ¼
Canada	0.6	10.3	10.1	12 ¼	12 ½
Austria <sup>1</sup>	5.5	10.5	7.9	7 ½	7
Belgium	7.8	12.9	9.3	9	7 ½
Denmark	1.9	14.1	11.2	10	12
Greece	1.1	18.2	27.2	25	23
Ireland	0.4	17.6	21.1	18	17
Netherlands <sup>2</sup>	9.5	10.6	4.6	4	5
Norway	1.1	11.8	9.4	9 ¼	10
Spain	1.4	22.8	18.5	16	14
Sweden	2.9	11.0	8.9	9 ¼	7 ¾
Switzerland <sup>1</sup>	5.7	6.3	5.1	6 ¼	4 ¾
Total of above <sup>4</sup>	73.4	12.88	12.18	11.31	10.71
Germany	–	8.7	6.2	5.0	4.25

<sup>1</sup> Monthly earnings.

<sup>2</sup> Hourly rates.

<sup>3</sup> Weekly earnings.

<sup>4</sup> Weighted with the above shares in German exports.

Sources: OECD Economic Outlook, Dec. 1981, p. 43; Deutsche Bundesbank, Reihe 3, Tab. 2 c.

□ Import prices have been falling since last October, even on a seasonally adjusted basis: world demand for raw materials is sluggish, both dollar and Sterling exchange rates have come back somewhat against the Mark, and domestic demand is very weak. In August 1981 the year-on-year rate of import price increase was at 20 %, in January the rate had come down to 6.9 %; lower rates are ahead.

□ Finally, interest rates which are the cost for the use of real capital will continue to edge down in coming months.

For consumer prices this means that the forecast of the German Council of Economic Advisers of a 4 % increase over the course of the year is not unrealistic.

### **Counterproductive Monetary Policies**

To be sure, the latest year-on-year rate of consumer price inflation is still beyond 6 % and it is this figure, and not the favorable outlook which impresses the public in Germany, inflation-sensitive as it is after the two currency reforms of 1923 and 1948. The Bundesbank certainly considers the inflation rate still as much too high. By historical standards this is indeed the case. But a substantial portion of that inflation is not home-made but results from increases in oil and other raw material prices as well as from the decline of the Mark's real exchange rate. Contrary to the neo-classical paradigm, an inflationary push in one sector of the economy can and will not just be compensated by lower increases somewhere else: it usually results in a higher rate of overall inflation. Monopolistic and oligopolistic market structures plus the spreading of labor, credit, rent and other contracts which include some sort of automatic inflation adjustment continue to erode the flexibility of the price mechanism – not only in Germany.

A monetary policy which attempts to bring down inflation in such an environment by a reduction of monetary growth will usually lead to employment problems, even if this is done cautiously and step by step, and especially so if there is already a strong deflationary impact. In Germany, monetary policy actually went beyond such a gradual approach and applied a sort of shock therapy by pushing back the rate of monetary expansion from rates of over 10 % in the two years before the spring of 1979 to rates of 5 % and less since then (central bank money). It reacted as if the higher inflation rates had mostly domestic roots.

In a recession the preoccupation with price stability may sometimes be carried too far. It is often overlooked that restrictive monetary policies not only reduce inflation through their impact on final demand, wages

and import costs but simultaneously add to inflation. The negative productivity effects of falling capacity utilization rates have been mentioned already. The higher cost of borrowing also means a rise in the cost of investing in new plant and equipment, as well as in the cost of holding inventories. The rising public sector deficit in turn tends to keep up inflation expectations which then feed directly into the actual price index.

A policy which keeps inflation significantly below interest rates at all times benefits the holders of financial assets, of course, and thus maintains the viability of the financial system. But this viability will also be given if inflation is permitted to fluctuate more than is presently the case in Germany. Japan is the prime example for this. At some times, the interests of the savers have to be protected, at other times it becomes necessary to do something for the debtors, actual and potential, people who want to build a house or invest in new machines. During the late phase of a boom, when inflation rates are on the rise, savers need support from the central bank. Higher real interest rates are called for. These also help to dampen final demand and to reduce a current account deficit by promoting the purchase of domestic financial assets. The hour of the investor strikes when it is time to end a recession. Jobs are needed in such a situation, and spending on hardware – plant and equipment – must be made relatively attractive; real interest rates have to fall by means of a more generous supply of central bank funds. It does not hurt if business gets convinced that prices will rise somewhat faster than they do at the moment; improved profit expectations depend on both higher sales volumes and higher unit prices.

Just as the real economy develops cyclically along a growth path, and just as cycles are at the very heart of any, not only economic, development process, as Schumpeter has taught us, it is essential not to take each acceleration of inflation as a signal to step on the monetary brakes, especially if it is not the result of an overheating in the economy. Sometimes a boom has to run its course. If this is not permitted and the short-term trade-off between inflation and unemployment is decided in favor of lower inflation, the level of unemployment has to be higher after such an exercise. This is a fair description of what has happened in Germany.

What made matters worse is that the slow-down in potential GNP growth which at least partly resulted from such a policy was then again taken as the basis of an even more ambitious monetary target, which is usually arrived at by multiplying the actual potential GNP growth

rate (presently just about 2 %) by what is regarded as an "unavoidable" inflation rate during the coming year, thus perpetuating slow growth.

### Investment Boom Needed

In its recent annual report, the German Council of Economic Advisers, known as the five wise men, presented a calculation which showed that even if existing physical production capacities were used fully, only 400,000-600,000 more persons than today could be provided with jobs, while 1.5 million members of the German labor force would be left in the cold. Since the labor force will rise by 0.5 million by 1985 and by another 0.5 million by 1990, to reach a total of 28.5 million, a return to something which resembles high employment requires that the number of jobs available in the business sector rises by 1 % or 2 % annually, depending on whether the task is to be accomplished by 1985 or 1990. In the first case, real spending on plant and equipment has to grow by 12 % during four consecutive years, in the second case nine years of 5 to 6 % annually are called for. These calculations are actually rather optimistic in that they assume that the capital intensity of newly created jobs does not rise as fast as it did the past, the reason being that labor has become and will remain relatively cheap compared to capital.

An investment boom of this kind requires a quick and substantial cut in short-term interest rates. Expectations of gradually falling rates would only postpone the eventual recovery. The relative attractiveness of investing in real rather than in financial assets has to be improved, and the earlier the better. In Germany, the central bank is not suffering from a crisis of confidence which makes life so difficult for the Fed, and it will be able to get rates down handsomely if it decides to do so, short-term rates as well as bond yields. There can be no doubt about the political independence and the resolve of the Bundesbank.

It is often argued in the German public discussion that actual (net) interest payments by business play a relatively minor role compared to labor costs, and that a rate cut would thus do little for company costs, profits and investment plans. This assumes that the existing capital stock is there cost free as long as it has been financed internally or through equity. The business sector's capital stock (excluding housing), estimated to have been DM 1,700 billion at replacement cost in 1981, yields services just like labor – and at a cost, of course. The interest rate which business typically applies is closely related to the long-term rate in the financial

market, and thus around 10 % today. A one percentage point reduction in that rate relieves the cost calculations by DM 17 billion which is far from negligible. If the housing sector were included, the figure would be even bigger. For comparison: a one percentage point increase in gross compensation of all employees, in the private and public sectors of the economy, amounts to DM 8.7 billion. In contrast to a popular notion, long-term rates are not independent of short-term rates, and would follow a decline of the latter, as banks and other large investors on the bond market begin to mismatch maturities, to finance long-term assets through money market or other short-term debt.

There is another argument, used by the Bundesbank to defend its high interest rate policies: a rate reduction would lead to a devaluation of the exchange rate and thus to higher import costs and domestic inflation. If the exchange rate, as during much of last year, is mostly a function of interest rate differentials, such an effect may indeed occur; given the very sluggish behavior of final demand in Germany and the huge slack in capacities, a passing on of the higher cost may be difficult: profits would suffer further. However, a currency depreciation has not just a negative impact on costs, it also helps to boost sales on foreign markets; the trade surplus would rise even further beyond the DM 40 billion or so estimated for 1982. Any firm which is faced with flagging sales and underemployment would reduce its prices; a depreciation does the same for a country. With the improvement of German foreign balances since October of last year, the interest rate connection, especially with the dollar area, has become much weaker. A further decline of the Mark in the wake of an interest rate reduction will be temporary and only provoke a stronger rebound later on. Actually, there is a chance that capital imports, triggered by the expectation of lower interest rates, prevent a devaluation in a situation where the current account shows signs of improvement. Japan made this experience in August, 1980. To be on the safe side, the interest rate cutting process could be coordinated, at least within the EMS area, including Austria and Switzerland.

On balance there is little which still argues against a determined reduction of interest rates in Germany. The economic system itself will increasingly get under attack if it fails to provide full or at least high employment in the not too distant future. One interventionist employment program after the other will be introduced, with all well-known effects on resource allocation, i.e. productivity, and government deficits. In a situation as it exists today the most effective supply-side program is to stimulate demand again via lower costs of funds.