

PRIME MINISTER

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The German Economy

Last week I spent two days in Germany as the guest of the Konrad Adenauer Stiftung. It was a very stimulating experience.

From conversations with politicians, officials and academics I came away with two clear impressions: one was the sluggishness of the German economy and the other was a better understanding of their opposition to further reflation.

a. The Sluggishness of the German Economy

I had not appreciated before the extent the German conception of the social market economy is rooted in corporatism. It is quite different from the concept of the social market economy, which Keith Joseph sought so eloquently to justify in this country in the mid-1970s. Our use of the term refers to those constraints which governments place on markets to make their workings acceptable to the community. By contrast, in Germany, it refers to the partnership of government and trade unions alongside business which is perceived as being at the very heart of the wealth creation process.

As a way of establishing a common purpose following the Second World War the social market economy suited Germany. But it now seems that the dynamism which their economy possessed in the 1950s has faded, mainly because



of the weight of increased regulation, the growth of bureaucracy and the powerful grip which trade unions have over traditional industries such as coal, steel, shipbuilding and chemicals.

This has produced a North-South divide. Bavaria and Baden-Wurtemberg (Munich and Stuttgart) in the south are booming areas in which new high tech companies typically wish to locate. By contrast, the Ruhr and North Rhine Westphalia show the familiar signs of the adjustment which parts of our North went through in the early 1980s: the closure of coal mines and steel works accompanied by a great deal of industrial unrest.

Powerful unions such as IG Metall add to the problem. IG Metall for example as a metal union, covers both steel and car companies. Recently, they negotiated a wage increase of 11% which applied not only to the successful Daimler-Benz company in Stuttgart but also to troubled steel companies in the Ruhr, which are already in the process of shedding labour.

The most prestigious of the German economic research institutes, the IFO in Munich, in the December 1987 issue of their journal attach considerable importance to this point.

"Especially disquieting is the lack of a greater differentiation of the wage-agreements by skill, branches and regions, which is urgently needed to raise the level of employment. Thus the shipbuilding industry, which is very dependent on subsidies, adopted the wage-agreements of the metal industry. With such behaviour wage policy diminishes the employment chances of this branch, unless the

government increases the subsidies; the resulting



high wage level makes it more difficult for shipbuilding locations to attract firms from other regions."

One of the most revealing statistics and one of great concern to German policy makers is the growth in employment, especially when compared to the US. Over the past two decades or so, employment in the US has increased by around 30%, while in Germany employment has fallen by 2%. (Over the same period it has also fallen slightly in the UK). Over recent years the service sector in Germany seems distinctly more sluggish than in other countries and one suspects that the social market economy does not pay sufficient attention to the need to create jobs and firms.

This statistical record is also backed up by more qualitative evidence:-

*At present they have the closing hours at 6.30 on weekdays and, mostly, 2 pm on Saturdays.*

(a) One example of perverse regulation is evening closing hours for shops. Politicians face great difficulty in trying to extend the opening hours and encourage the service sector

(b) the recent cyclical recovery is much lower than the previous one

Recoveries compared - GNP growth  
(% real growth at annual average rates)

1978 H2  
1975 H1

4.0

1986 H1  
1982 H2

2.4



suggesting that capacity growth itself may be slowing down.

- (c) the German response to the pressures which led in this country to Big Bang are to say "But we've had universal banking forever". These universal banks however have not been that responsive to change. The most recent example is the CD market in DM. Until a year ago the Bundesbank would not allow this market to develop. When they did, it was subject to a stamp or turnover tax. As a result one year later nearly all CD trade in DM is taking place in London.
- (d) the emphasis the Germans place on the supervisory boards of companies is really a way of dealing with a different era of trade union power: modern technological changes, the creation of small businesses, the enterprise culture all make this approach out of date. They are still fighting yesterday's battles. Yet the boards take up management time and resources which they can ill afford.
- (e) total government subsidies, including payments to the EEC have remained at around 5% of GNP for some time.

#### Conclusion

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The social market economy has become a way of justifying the innate conservatism of a wealthy society responding to pressures for change. It is almost as if they have been so successful for so long that they dare not change a winning hand.



The Kohl government is not tackling the problem of supply side rigidities and has not succeeded in changing the composition of government spending away from subsidies.

b. Should Germany reflate?

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The commonly held view is that Germany is not doing enough to expand demand at a time when total expenditure in the US is being cut.

During my visit last week, however, I was surprised at the strength of German feeling against additional reflation, especially as it came from people whose arguments on other issues tended to be plausible. Before assessing their argument it is worth putting forward their case.

- (a) First they have very unhappy memories of the 'locomotive' role which they played after the 1978 Bonn Economic Summit: they cut income taxes, increased government spending and then after two years (although partly the result also of the second oil price shock) inflation doubled, the current account moved into deficit, the government deficit rose strongly but unemployment was little affected. As Mr Poehl has said this episode has "consequences that do not exactly encourage imitation."
- (b) Second the Germans fear the inflationary consequences of monetary overshooting. It now looks as if the target for the growth of Central Bank Money will be overshot in 1987 as it was in 1986. The 1987 CBM target is 3-6% and its growth is between 7½-8%. The present rate of inflation of ½% is put in jeopardy by such overshooting. If interest rates were lowered and the



DM were to weaken this would simply add further inflationary pressure.

- (c) Thirdly the most powerful reason for rejecting external pressure to reflate in their desire to pursue a medium term fiscal policy. Their declared goal is to reduce the ratio of the Federal Government deficit to GNP to 1.0% by 1989.

Table 1 - Government Deficit as % of GNP

	<u>Actual</u>	<u>Forecast</u>	<u>Target</u>
82	4.9%		
85	2.1%		
86	2.2%		
87	2.7%		
89			1.0%
90		3.9	

As can be seen from Table 1 they reduced the deficit substantially between 1982 and 1985 largely due to cutting public spending. Since then it has been edging upwards and their internal forecast, which is not published, is that it will rise to 3.9%.

*How much due to industrial subsidies?*

They see a number of factors driving public expenditure higher

- increased industrial subsidies (coal, steel, shipbuilding) to deal with the run-down of the Ruhr, which is far from over;



*Jan higher than ours.*

- EEC contributions, airbus etc.
- the fiscal implications of the falling birthrate (between 1973-83 the proportion of the population under 15 years old fell by 25%): OECD estimate that transfer payments to the elderly in Germany by the end of the century will be the highest of any member of G7.

They are also concerned with the problem of public sector debt. As can be seen in Chart 1 this has risen considerably over time - partly because of large fiscal deficits but also because inflation has been so low. (most countries with large deficits have high inflation so this problem does not arise) This contrasts within the UK.

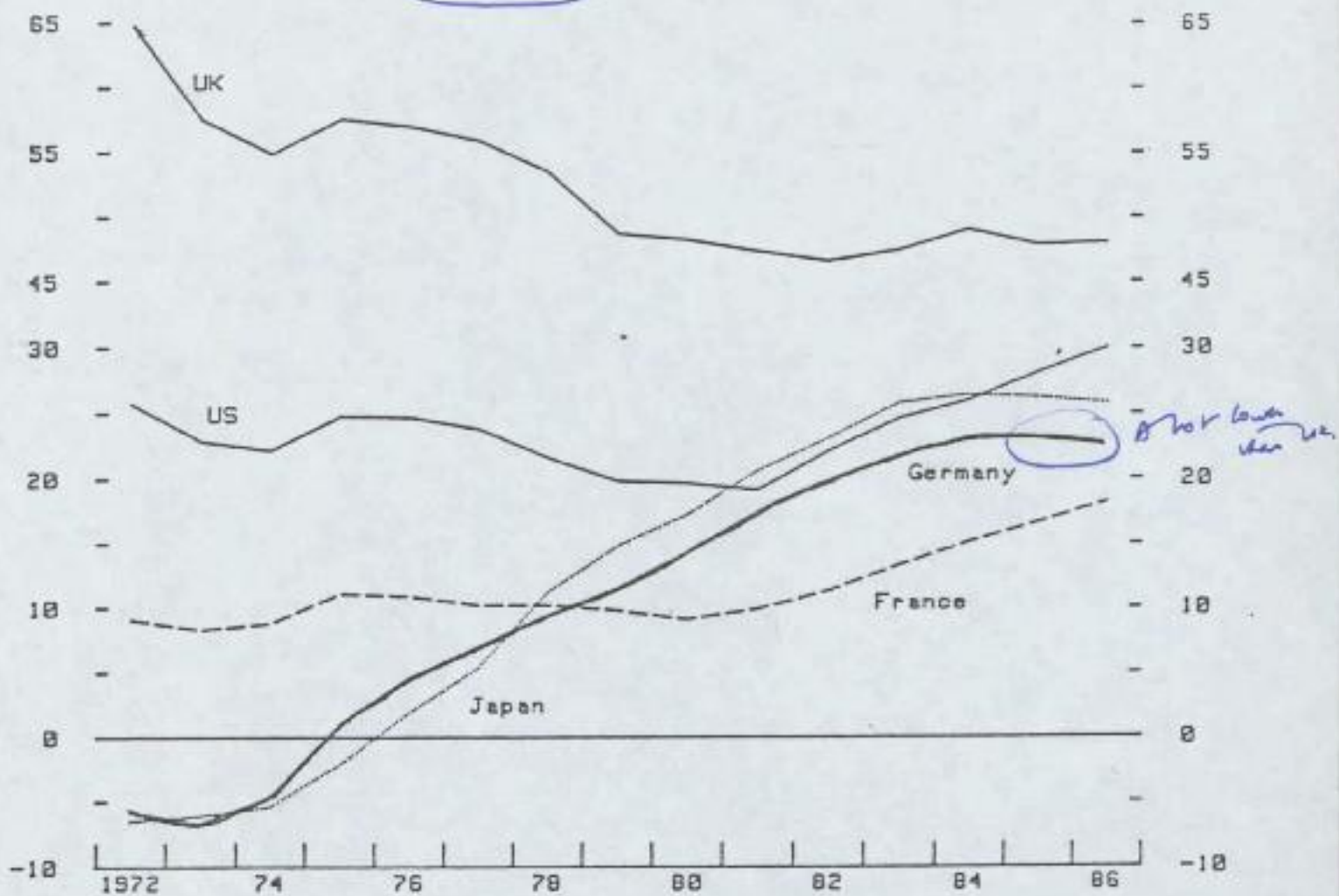
*But own debt/ GNP is much higher than them and all other OECD countries*

(d) Although the balance of payments is in substantial surplus it is falling. More than that the substantial appreciation of the DM since 1985 and especially recently involves a period of time before imports rise and exports fall - the J curve effect. They claim it would be wrong to take expansionary measures at present as their surplus is already set to fall.

(e) Finally they believe they have already taken modest additional reflationary measures - on 2nd December the government announced measures designed to provide Dm 21bn (\$12.7bn) of investment over the next three years through a programme of subsidised lending to local authorities and to small and medium sized companies - the Bundesbank has reduced the discount rate to 2½%, a record low.

# Chart 1

Public Sector Net Debt / GNP Ratios for the G5



Source: Table 2, OECD Working Paper No.30, by Chouraqui, Jones and Montador.



Conclusion

One cannot but have sympathy with the German government's declared intention of pursuing a medium-term monetary and fiscal policy which is anti-inflationary. After all this is what we preach and practice. Their room for fiscal manoeuvre is very limited - about the most I think they could do would be bring forward the 1990 tax cuts of DM 20bn to 1989 but even that might be a risk.

If governments pursue credible non-inflationary medium term monetary and fiscal policies the capital markets and the foreign exchange markets can be relied on to take up the residual pressure. I suspect we are on the wrong tack by trying to make Keynesians out of the Germans. We are not

A Final Thought

Perhaps the most important impression I received from my visit was finding a greater element of self-doubt than I had ever realised might exist among Germans. It reflected their failure to tackle the supply side of the economy, the fall in the population and the birth rate - which they see as loss of confidence in their whole culture and place in the world, and their ability to remould institutions (especially companies) for tomorrow's world.

They are very envious of what you have achieved in this country and of our new found self-confidence.

Brian Griffiths

BRIAN GRIFFITHS

*try to make Keynesians out of themselves by pulling up the interest rate (as a time of boom!) We are not doing that*

*have no idea of their economy or society in such a way that they have a permanent surplus. And they are still talking about a surplus.*

*and*