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British Embassy
BONN

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Sir,

THE ECONOMY OF THE FEDERAL REPUBLIC OF GERMANY: HICCUPS OR FEET
OF CLAY?

1. When I arrived in Bonn in September 1984, the German economy was regarded as a model for us all: dynamic, resilient and well-managed. In that year, emerging from the recession which followed the 1979 oil shock, it grew by 3.3%. Exports increased by 12.9% to reach a net surplus of DM 54 billion. Inflation stood at 2.4% on a downward curve. Today, in March 1988, figures for the last full year show the trade surplus at DM 117.5 billion. Inflation hovers around zero. Yet while Germans earn grudging admiration for the continuity of their performance, little praise comes their way from the commentators. Rather the opposite. To their dismay and confusion, and not a little resentment, they find themselves, for the first time since the end of the war, the object of international criticism, some of it fierce. The analysts have discovered that the German economy has been "under-performing" for years. So what has changed? Not so much German performance, it would seem, as the way it is viewed. What is one to make of this? Is the German fall from grace simply the result of changes in fashion in economic analysis? As and when these change again, will there be a reversion to the status quo ante in the way the German economy is seen? Possibly. But anyone living here, let alone those abroad examining Germany's vital statistics, can tell that something is wrong. After four years of growth, industrial production fell back last year for the first time since Chancellor Kohl came to power. Total investment is falling as a percentage of GNP. Unemployment has resolutely refused to go below 2 million and has recently been rising, albeit slowly. Why the stagnation? What is going wrong? A case of hiccups? Or do we see feet of clay? To use the experts' jargon: is the problem cyclical or secular? Or if it is a mixture - certainly not to be excluded - which is it predominantly? What does it mean for the future of the German economy? And what in turn does that mean for us in Britain?

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2. I would date the beginning of real trouble to 1984-85. This may seem an odd date to choose, since it was then that the government of Chancellor Kohl began to correct the shortcomings of Schmidt's economic policies. Inflation fell rapidly. Between 1981 and 1986 the Federal borrowing requirement was reduced by roughly 40%. But the restoration of stability combined with growth had less to do with the government's measures than it realised. The much more favourable international conditions of the early eighties, notably the drop in oil and commodity prices and strong US demand, were prime contributors. The German economy flowered and exports went up and up. By 1986, however, the effects of this largely externally generated expansion had begun to peter out. In an economy with a high propensity to save, the forces of stability were once more beginning to triumph. A vital stimulating ingredient was missing. The Coalition had initiated tax cuts, in one of the most highly-taxed countries in the world, but it had failed to deliver its 1984 promises of structural reform: notably reduction of regulation and subsidies, and liberalisation. The tax base was not in consequence becoming bigger. Small wonder then that one of the most probable results of the latest modest round of tax cuts, which came into effect at the beginning of this year, seems likely to be an increase in the government's borrowing requirement to levels higher in nominal terms than those achieved by the supposedly free-spending Schmidt. This has thoroughly scared the Federal Government: in the midst of their tax cutting programme they have announced the prospective imposition of new consumer taxes to fill the revenue gap thereby created. Meanwhile the object of the exercise, stimulating growth, has virtually been lost sight of. Growth is likely to decline once again this year to 1.5%, if that. Government complains that there is no objective reason for business confidence being so low or investment intentions so cautious. The business community regards the efforts of Government as at best an irrelevancy and at worst actively damaging to prospects. Why the mess? And why, when the Coalition announced on coming into power that it would carry out structural reform, and when that reform is so badly needed, has it not so far happened? The explanations lie at several levels: economic, social, political and psychological.

3. To start with, there is the very structure of the German economy. Today, production of goods constitutes 41% of GNP. Services account for another 41%. In 1980, industrial production accounted for 43% and services 38%. In 1950, the figures were 40% and 26% respectively. This pattern is in marked contrast to the US, Japan, or indeed the UK, where services now account for some 60% of GNP. It reflects German strengths and weaknesses, which as so often tend to mutual reinforcement. Historically, German industry has been and remains dominant over services. German manufacturers are well organised. They make long-term plans for production, marketing and sales. Traditionally, they have invested accordingly. They manufacture high-quality goods, made by a workforce that has gone through complex, not to say long-winded, apprenticeships which foster loyalty and discourage labour mobility. The tradition of financing company

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investment through the house bank brings about Zaibatsu-like corporatism among the bigger German companies. Venture capital is almost non-existent as a technique for raising money. Centralised wage bargaining conducted by powerful unions makes the labour market relatively inflexible and acts as a barrier to the growth of small-scale entrepreneurship.

4. German services share many of the same organisational characteristics. But the service sector is definitely the handmaiden of industry, often required to serve other interests before its own. Thus the high cost of electricity is determined by the obligation to buy German coal rather than by the much lower average cost of nuclear energy; road freight rates are regulated with the subsidy to the Bundesbahn in mind; and bowing to the wishes of the unions, the federal legislation on shop opening hours stands unreformed since the days when Hitler depressed consumption to promote the war effort. Overheads in the retail sector are high, but so is quality, which the German customer has come to expect and demand. He fares much less well where he has less choice, especially in financial services which are heavily regulated and protected in the name of financial prudence. Companies rarely go bust but neither do they rush to innovate. Quality, strength, stability and inflexibility are hallmarks of German services as of German industry. But there is one big difference. Whereas in industry pressures towards higher costs - Germany is moving steadily towards a high-wage 35-hour week - have ultimately been contained by the need to maintain international competitiveness, this has not been the case with services, which have had neither the freedom nor the ambition to conquer the world. So far they have preferred and have needed the home comforts of protection. And they are not exactly clamouring to be unshackled. When the government has threatened to alter their cosy environment by increasing domestic competition, or when the European Community has proposed outlawing protection, the forces of German reaction have risen up: well organised, articulate and persistent in their trade associations, the special interest groups have operated behind the scenes as well as in front. And so far they have got a large part of their way. Last year's published version of the long-awaited Witte Report, on the future of the telecommunications industry, saw the strong medicine prescribed in earlier drafts transformed into pretty thin gruel.

5. The laissez-faire - the non-interventionist style of day-to-day post-war Federal German economic management - should not blind us to another important feature of the industrial scene: the very considerable extent of government intervention in the structure of the economy, through regulation, subsidisation and to a lesser extent direct public ownership. According to the Federal Finance Ministry's 1987 report, the Federal total of subsidies in 1986 was DM 30 billion (1.7% of GNP). If we add subsidies financed by the Länder (which have almost complete autonomy in financial matters), by the local authorities and by other governmental bodies, the total rises to DM 74.5 billion. Free market economists at the University of Kiel estimate that the real figure is around DM 130 billion. The truth is probably somewhere in between. While a substantial proportion of this public money is channelled into housing and agriculture, the Federal and Länder Governments also spend a lot on the service industries, and on certain sectors of manufacturing, particularly the "rust belt" industries - coal, steel, shipbuilding - and in such politically sensitive areas as

West Berlin, the Eastern Border Zone and, more recently, the Ruhr. All of which goes to show that Germans are far from averse to spending public money in the market place. After the bitter experience of the Weimar Republic, they have collectively set their face against outright consumption-led booms. They think this is what the Americans are after, and they are not prepared to concede it. But they are less particular about using public money to conserve - and even to create - jobs if the ostensible purpose is to cushion the impact on individuals of economic change. They are hardly alone in subsidising "rust belt" industries and agriculture. But the scale has been characteristically generous and thorough. Even within manufacturing, not inconsiderable public resources now lie stacked in the balance against rapid change. In last year's survey on Germany, the OECD noted that "in international comparison for the period 1970-1983, Germany ranks third to last as far as the magnitude of structural changes is concerned".

6. Structural economic reform in the Federal Republic would thus require at least as great a disturbance in relations between central government, the regions and sections of business as it has done in the United Kingdom. Possibly more so. But that does not detract from its desirability nor make it, per se, impossible. How likely then is it to happen? Here we enter the realm of the aspirations of society, and of political will.

7. In this, as in some other spheres, the kind of debate taking place in Britain and France is largely absent here. The President of the BDI (CBI equivalent), Tyll Necker, has mounted a campaign to promote structural change in the interests of maintaining international competitiveness. But Government shows no great urgency and the service industries are not crying foul. The customer is making no fuss. (One of the interesting features of the German scene is the weakness of the consumer lobby as compared to the strength of the environmentalists, many of whom would happily add further to industrial costs.) Just as important, there is little perception among the general public that the economy is performing less than optimally and - justifiably enough - there is no general perception of failure. It ought not to take a catastrophe to bring about change in a well-educated society, but it took us in Britain a long time to get the message. And, for Germans, there is what they see as the compelling need to maintain "solidarity".

8. Germans admire the renewed vigour of the British economy. But many, even our most fervent admirers, look askance at some of the side effects. The German Chancellor's response to the recent wave of unrest among steelworkers in the Ruhr, who were protesting at the planned closure of the works at Rheinhausen (most of the workers having already been guaranteed alternative jobs at a nearby plant), was to call on 24 February a national conference of steel companies, unions and relevant government Ministers (the "social partners") to decide on help for the Rhineland and the Ruhr regions. The result has been a package of new regional

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investment up to a total of DM 1 billion over 4 to 5 years to be financed on a matching basis by the Federal Government and the Länder, together with various ambitious infrastructure investment programmes, particularly in the fields of transport, telecommunications and research and technology. This is "Solidarität" in action - the acceptance that the citizen has certain economic as well as political rights vis à vis the employer and the state - as exemplified by a social security and benefits system which is more generous than any other, Scandinavia possibly excepted. Germans will tell you that theirs is a social market economy. Government intervention in the economy is readily accepted when it is designed to protect the individual and assure social justice. Not perhaps so different from the kind of thinking that until the late 70s would have commanded wide acceptance in Britain? But it is still going strong here. Why? The stress on solidarity is not so much the invention of a left-of-centre political credo as a product of modern German history: the national resolve never to repeat Nazi cruelty to minorities and social incompetents, and the memory of what was achieved by working together in the hard years of immediate post war reconstruction. This combination, the economic rights of the individual plus the political need to do right by the individual, gives continuing life to paternalist intervention.

9. I turn from the social to the political factors. Jonathan Carr wrote in the Economist last year that it was a wonder that any decisions were taken in Germany. I need not here describe the additional complications which a Federal system of government brings to decision-making, nor the uncertainties which Coalition policies inject. Suffice it to say that the German political system is ponderous and indecisive. Germans believe that their political stability depends directly upon the health of their economy, measured for most people by the monthly trade and inflation statistics. So far, neither of these has failed more than momentarily. The paradox is that, in order to ensure the continuation in the future of this high level of economic performance on which he believes the nation's political stability to depend, the citizen should be prepared to allow the necessary economic changes to take place. But public awareness of the costs of present economic shortcomings and of the finiteness of public resources is low, while the ordinary German's desire for a high social wage and a "compassionate society" wage remains very strong. The combined weight of the political, economic, social and psychological factors working against major structural change has hitherto usually been overwhelming. Notwithstanding all this, I still believe that at least some of the liberalisation which the Government has promised will take place over time. What could propel this along and how much change will there be?

10. Decisive political leadership would be one answer. But laissez-faire management traditions do not readily translate themselves into clarion calls to economic reform. The Chancellor is no economic thinker and acts only when he can see economic problems threatening to turn into a social and political crisis, as in the Ruhr. Moreover, he is not surrounded by a strong or

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forward-looking economic team. Bangemann, the Economics Minister, is the only fully convinced publicist for liberal ideas, but he has limited political influence. Kiechle, the Agriculture Minister, is the exact reverse as regards both ideas and influence. Stoltenberg, once a rising star, now more resembles a dying sun. Blüm, Minister of Labour and Social Affairs, stumps the country trying to jolly workers out of their mood of protest, and employers out of their gloom, by force of personality and appeals to solidarity. But Blüm's answer to rising unemployment seems to lie in the direction of further palliatives rather than in giving Bangemann's ideas for liberalisation a helping hand.

11. There is also the Bundesbank. I find its silence one of the greater curiosities of the scene. Much has been written about the supposed - and indeed real - tensions between Bank and Government at the end of last year. These revolved around a number of issues related to the problem of economic growth, including interest rate policy and the priority and the style appropriate for international co-operation to support the dollar. But there has been no unambiguous and public support from the Bank for the goal of reducing subsidies and increasing competition. As the constitutional guardian of the health of the currency, one would have thought this a natural cause for the Bundesbank. Perhaps the reason is that the Chairman, Karl Otto Pöhl, is a Social Democrat. Perhaps it is because representatives of the Länder governments, far from convinced that they want their happy cohabitation with industry to end, sit on the Central Bank Council. Perhaps it is the power of the existing social consensus. Whatever the reason, the voice of the Bundesbank in backing reform is at best muffled. And even if it were raised, and loudly, I am not sure that it would have a decisive effect. The net effect is that while the Federal Government remains attached, in its public utterances, to the need for liberalisation and economic reform, in practice it has few, if any, allies willing to fight for these causes. With a few exceptions, the banking and business communities are more ready to criticise the methods than to give public support to the objectives. And, as I have explained, arrayed against any given measure of reform - for instance, the current plan to reduce the cost to the public purse of health care - are the big battalions of the special interest groups.

12. I mentioned Kiechle as another exemplar of how to restrict rather than enhance competition. But the Great Brussels Battle over agriculture has had some interesting effects. It is in this area, and so far, in this area alone, that the German public has been exposed by the actions of the Government and by commentators to the idea that its interests are not necessarily synonymous with those of a special group, however powerful their emotional appeal, and to the proposition that subsidies need to be reduced and competition increased. There could be an important lesson here: that the main agents of structural change in the FRG will be external, not internal. There is the OECD, where useful influence can be brought to bear on German macro-economic management; and there are the negotiating fora of the GATT on the one hand and the Community and the member states on the other. Of these last two, the EC is likely to be the more important over the long term.

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13. Germany's external trade policy lies beyond the scope of this despatch. Suffice it to say that it has by and large been a great success story. The Federal Republic has both preached and practised free trade. In goods. Now that both agriculture and, further down the line, services are on the agenda of the GATT, the situation is somewhat more complicated. No doubt the Germans will drag their feet, using all the devices for retarding progress which Community procedures for international negotiation offer. But they do know that in the end, in order to preserve access for their industrial goods, they will be obliged to make concessions in other areas. Those more versed in the GATT than I am will have a better idea of how soon and how far such concessions would need to be made. My guess is that in agriculture, bargains struck in the GATT will eventually have a measurable impact on levels and structure of production in participating states; but that in services, the possible GATT Provisions on Services notwithstanding, the effects will be much slower and more intangible, bringing about domestic structural change in Germany only imperceptibly, if at all.

14. Thus I would put more faith in intra-European trade relations than in GATT as an agent of change. Over half of Germany's trade is conducted with her Community partners and the percentage grows every year. The recent agreement in Brussels has brought with it the prospect of some acceleration of the structural change in German agriculture which began many years ago. The initial response to the resulting dislocation is quite likely to be further nationally-financed subsidisation and assistance to individual farmers, over and above that paid for by the Community. In the longer term, however, it will not be easy for Bonn to find the financial resources necessary fully to counteract the effects of the downward pressure of lower real prices - always assuming that this pressure is real and sustained. I would expect that, over the next decade, the Germans will find ways of preserving, more or less, their rural way of life, and the appearance of their countryside to which they are so deeply attached, by means other than excessively subsidised agricultural production.

15. When it comes to the reduction of industrial subsidies and to the deregulation of services, it is less easy to see how policies so far generated in Brussels will have the same concentrated impact as CAP reform is intended to have on agriculture. But there are instruments available. The Commission will shortly produce its Community-wide study of subsidies and regional aids. This Embassy is providing as much information as it can to help the Department of Trade and Industry ensure that the Commission paper is accurate and comprehensive as far as the Federal Republic is concerned. Follow-up work in the Council will be crucial. A moment when Community expenditure on regional policy is about to increase appreciably - even if mainly in the Southern member states - is a time when, I suggest, a major effort should be made to get to grips with distortions of competition throughout the Community.

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There is a British interest (shared with the Germans) in preventing abusive expenditure in other member states. The Commission should apply sustained pressure on the FRG to do away with at least the grosser forms of industrial subsidy and to reduce the excessive geographical extent of qualifying regions. The European Court could be useful. Germans do not necessarily see its verdicts against them as national defeats. Rather, such judgements can serve the purpose of forcing through changes which the Federal Government has not been able either to impose (very difficult in this political system) or to develop a consensus in favour of.

16. In the area of services, especially, I see the deadline of 1992 as offering the Germans a challenge and ourselves an opportunity. With the argument over the Delors package largely out of the way, the Germans are now gearing themselves up to formulate a Single Market package to push through before the end of their Presidency. They hope for progress towards a liberalisation measure to which they are very attached, that of free capital movement. British support for the goal of a Single Market is well known. But is there scope for giving greater priority to measures that would promote deregulation in the Federal Republic in areas of interest to us? To give one example: it will require more than contact between Transport Ministers to shift the Germans on road transport liberalisation without attaching wrecking "harmonisation" amendments. The message that liberalisation means faster growth needs to be got across more widely here. Two things we ought not to allow. First, we ought not to leave the running to the new Franco-German Economic Council, which I believe will be given a role to justify its existence. And secondly, our service industries must not be caught napping as and when further opportunities do present themselves on the German market.

17. "Mehr markt, weniger Staat": More market, less State. This was Kohl's slogan when he came into office. By the time he leaves (and at present he seems likely to survive up to and after 1990) we shall see market forces operating in the economy to a rather greater extent, and rather less state intervention. In other words, there will be some further deregulation and liberalisation. The requirements of 1992 will in particular have some impact. But, for all the reasons I have already set out, there is no question of a return to the reality, let alone the theory, of the German economy under Ludwig Erhard. It is not feasible and it is not wanted enough by any significant section of the community. I do not therefore see the German equivalent of the Maekawa report on the horizon, nor the formation of a national consensus to move in any new direction.

18. If a radical restructuring of the German economy is not on the cards for the foreseeable future, I equally exclude any sudden collapse. Daimler-Benz and Siemens are among the biggest privately-owned firms in Western Europe. Germany makes 30% more motor vehicles than any other West European producer and exports 60% of production. The German chemical industry is the second largest

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in the world, the machine tool industry by far the largest in Western Europe. These are strengths that do not disappear overnight: they go wide and deep in this country. I do not expect the German economy to petrify either. The preoccupation of businessmen with the creation of capital stock is likely to reassert itself. I believe that in the future they will, once again, invest at higher levels than they are doing at present, not only in existing strong sectors but also, for instance, in those penumbral areas between manufacturing and services such as leisure and environmental protection. I believe they will continue to maintain their traditions of product innovation and quality.

19. Broadly speaking, therefore, for as long as it is sensible to look forward, I would expect the economy of the Federal Republic to continue to operate much as it is now, at what has been called a high level of stagnation. There will be low but positive growth, with the DM retaining its high international exchange rate. Export performance will continue to be very strong. The fact that as compared with the UK only 10% (and a declining proportion) of German trade is with the United States is some protection against US dollar fluctuation. Other things being equal, an increasingly integrated European market will enable the Germans to gain from manufacturing economies of scale, and to profit from advantageous cost structures in neighbouring States. They are likely to sell more and more in Western Europe, developing the Eastern Europe market as a sideline. Just how dominant they can become in Europe will depend on the relative performance of others, notably Britain, France, Italy and Spain. Inside Germany there will be some modest structural reform and liberalisation. Will it be enough to start bringing unemployment down again? If, contrary to forecasts, growth and unemployment figures were to move in opposite and unhelpful directions, the Government would feel obliged to take further counter measures. Trade Union pressure is already there, giving work-sharing an airing. Without liberalisation, the possibilities for expansion are limited. Already low interest rates cannot be reduced much further. The present, and politically contentious, plan within the Coalition for tax reduction and reform does not look as if it will achieve enough, since the accent is more on shifting the burden around than in actually reducing it. Beyond this, the Government will face a choice if it wants to stimulate the economy: public expenditure measures and job conservation, or liberalisation. Or a bit of both. My hunch is they will shy away from clear cut choices and try always to sweeten the pill.

20. In the longer term, the size of the labour force will be a key factor in the structure of the economy and the prospects for growth. Women are steadily entering the German job market, which will simultaneously raise the unemployment figures and mask, at least for a time, the underlying drop in population. By the year 2000 demographers say there will be 6% fewer West Germans than today, and in 2020 20% fewer. If true, this forecast must have

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major effects. Who, or what, is going to pay for the support of the young, the sick and the elderly? Can it continue to be done by productivity increases? I doubt it. In another decade, the urgency for structural reform may seem much greater than it does today.

21. A cyclical or a secular problem? I do not think the current under-performance of the German economy has much to do with cyclical economic factors apart from the uncertainty created by the fluctuations of the US dollar. The real problems are structural and, for the time being, I see them persisting, certainly not untouched but in large part. The Germans will not, however, be able indefinitely to ignore the consequences of a diminishing work force. Their response to the challenge it will pose should reveal whether or not the feet are made of clay.

22. I am sending copies of this despatch to the Chancellor of the Exchequer and the Secretary of State for Trade and Industry, to the Permanent Representatives to the European Community and to the OECD, to the UK Executive Director of the IMF, to HM Representatives in EC, OECD and East European capitals and to HM Ambassador Moscow, and to the Governor of the Bank of England.

I am, Sir,
Yours faithfully

J L Bullard

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