1366

99th Congress
2d Session

JOINT COMMITTEE PRINT

S. PRT.
99-152

GERMANY'S COMING ECONOMIC REVIVAL

A STUDY

PREPARED FOR THE USE OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

MAY 15, 1986

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

59-440 O

WASHINGTON : 1986

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, DC 20402

JOINT ECONOMIC COMMITTEE

[Created pursuant to sec. 5(a) of Public Law 304, 79th Congress]

HOUSE OF REPRESENTATIVES

DAVID R. OBEY, Wisconsin, *Chairman*
LEE H. HAMILTON, Indiana
PARREN J. MITCHELL, Maryland
AUGUSTUS F. HAWKINS, California
JAMES H. SCHEUER, New York
FORTNEY H. (PETE) STARK, California
CHALMERS P. WYLIE, Ohio
DANIEL E. LUNGREN, California
OLYMPIA J. SNOWE, Maine
BOBBI FIEDLER, California

SENATE

JAMES ABDNOR, South Dakota, *Vice Chairman*
WILLIAM V. ROTH, JR., Delaware
STEVEN D. SYMMS, Idaho
MACK MATTINGLY, Georgia
ALFONSE M. D'AMATO, New York
PETE WILSON, California
LLOYD BENTSEN, Texas
WILLIAM PROXMIRE, Wisconsin
EDWARD M. KENNEDY, Massachusetts
PAUL S. SARBANES, Maryland

SCOTT LILLY, *Executive Director*
ROBERT J. TOSTERUD, *Deputy Director*

LETTER OF TRANSMITTAL

MAY 8, 1986.

Hon. DAVID R. OBEY,
Chairman, Joint Economic Committee,
Congress of the United States, Washington, DC.

DEAR MR. CHAIRMAN: I am pleased to transmit a study on "Germany's Coming Economic Revival." The author is Dr. John Starrels, staff economist. Also, the author wishes to thank Carole Geagley who typed the study.

The study reviews the recent course of West German domestic and international economic policy. The author concludes that supply-side reforms initiated by the Kohl government, combined with a resurgence in traditional German manufactured goods exports, have created the preconditions for a larger West German role in stimulating world growth.

Sincerely,

JAMES ABDNOR,
Vice Chairman, Joint Economic Committee.

CONTENTS

GERMANY'S COMING ECONOMIC REVIVAL

By John Starrels*

INTRODUCTION

After several years of retrenchment, the Federal Republic of Germany (FRG) appears on the verge of a major economic recovery. This is a significant development for both West Germany and the United States. For the FRG, improved economic prospects should allow it to again become the center of growth and technical innovation in Western Europe, which will, in turn, help West Germany close the technology gap between itself and its Japanese and American competitors.

For the United States, and the West more generally, West Germany's sheer economic muscle casts it as the natural leader in promoting a new burst of global growth. This is a role which the United States played in 1983 and 1984. But a reduction of America's burgeoning trade and budgetary deficits now requires a less expansive, outward reaching U.S. economic policy. West Germany is uniquely positioned to pick up the slack. It is the holder of the world's largest monetary reserves, $44 billion at the end of 1984, and in 1985 it ran a healthy trade surplus in excess of $30 billion. Germany grew nearly 3 percent in 1985, while holding the rise in its cost-of-living index at 2.2 percent, the lowest annual inflation rate in 17 years. According to the Paris-based Organization for Economic Cooperation and Development (OECD), the FRG could, if anything, improve upon last year's performance. It estimates that West German growth in 1986 could reach 3.5 percent.

Needless to say, West German leaders become nervous whenever they are told by allies that they should initiate more expansive policies to stimulate global expansion. Such nervousness is understandable. With a gross national product but one-fifth of the United States', and its domestic economic choices constrained by the demands of the welfare state and membership in the European Community (EC), Bonn (West Germany's capital) still insists that as a "medium-size power," its capacity to influence global economic developments remains limited. Even within these limitations, however, German business and political leaders may soon find it necessary to adopt a more active role in helping the United States sustain the kind of international order which has, in the past, proven so congenial to the market economies, including the Federal Republic of Germany.

In this paper, I examine both domestic and international aspects of the West German economic recovery. Chapters I–III accordingly focus attention on recent efforts to promote growth and innovation.

* Staff economist, Joint Economic Committee.

In the concluding chapter, I then discuss the international economic choices available to the Federal Republic in the context of its relations with the West; particularly the United States.

Background

As of May 1986, West Germany's return to economic health is reflected in surging profits of West German firms, large trade and current account surpluses, low inflation and, more generally, an improved environment for risk taking and entrepreneurship—factors which might very well enable West Germany to again become the powerhouse of Europe. Even the unemployment picture appears to be improving. The automative sector, for instance, has fully recovered from 1984's seven week strike and expects to increase its workforce by 40,000 in 1985.[1] Despite continued high rates of joblessness throughout the manufacturing sector, the West German Bundesbank (equivalent to the U.S. Federal Reserve) estimates that total employment grew by a quarter of a million in 1985. And analysts maintain that an equal, if not greater, number of jobs will be created in 1986.

To be sure, West Germany still confronts daunting obstacles to a new era of affluence and stability. Until the early 1980's, the Federal Republic of Germany built a comparative advantage on the foundation of its traditional manufactured goods industries, including a number—i.e., shipbuilding, steel, textiles, and construction—which have since been hurt by declining profits and high unemployment. Data assembled by Brookings economist, Robert Z. Lawrence, for example, shows an aggregate employment decline of 13 percent in this arena between 1980-84; running the gamut from −9 percent for electrical machinery, −21 percent for shipbuilding and repair, −23 percent for textiles, and −19 percent and −44 percent for basic metals and iron/steel, respectively.[2]

Moreover, within the ruling Bonn coalition itself, disagreement continues to exist over whether the national government's first priority should be the restoration of fiscal stability or the promotion of long-term growth. Economic policy in the Federal Republic of Germany follows the parliamentary norm of coalition politics. Regarding the present coalition, this places Finance Minister Gerhard Stoltenberg, a Christian Democrat, in opposition to Free Democratic Economics Minister Martin Bangemann on two major issues: increases in job program funding and an acceleration of the coalition's tax cut program; initiatives that Bangemann and other pro-growth advocates presently favor. But Stoltenberg insists that one of his government's major priorities must be further reduction in the Federal deficit. His close political association with fellow Christian Democrat, Helmut Kohl, and the greater prestige of his Finance Ministry have carried the day for Stoltenberg. As the next election draws nearer, however, pressures on the government to reflate could increase.

Outside the government, there are a number of other disagreements involving labor, management, and environmental groups

[1] *Financial Times*, September 11, 1985.

[2] Lawrence, Robert Z., "Industrial Policy in the United States and Europe," Tokyo, August 26-29, 1985.

over the long-term consequences of technological change. Automation and high unemployment, for example, have strained traditionally cooperative relations between labor and management in West Germany. While management seeks to cut overhead through labor-saving devices, labor naturally worries that their introduction will, if anything, decrease the demand for new workers while endangering the jobs of those already employed. In 1984, these disagreements came to a head when the printers' and metal workers' unions each went on strike on behalf of a five-hour reduction in the work week—from 40 to 35 hours. By reducing the number of hours, so these unions reason, jobs can be saved. These twin actions will be remembered as the longest and costliest labor conflict in West Germany's post-World War II history. The strikes were settled amicably. And West Germany's record as second best among developed countries in losing the least time to strikes in the past decade remains intact. But in a rapidly changing German economy, the politically gnawing question surrounding the issue of "technology versus jobs" remains to be answered.

I. The German Malaise

In an uncertain world, West Germany continues to embody economic influence and democratic stability. Writes American historian, David Schoenbaum:

> * * * It has integrated 15 million refugees, about a quarter of its population. It has weathered ferocious domestic debates on rearmament and ratification of a post-war status quo that conceded the permanent loss of a third of Germany. It has ridden out a short-lived neo-Nazi protest movement and a memorable student revolt. It has accommodated foreign enclaves representing up to 20 percent of the population of its major cities and learned to live with terrorism, energy constraints, record post-war unemployment, nuclear controversy, environmental hazards, and the possibility of zero growth.[3]

In the economic arena, these successes are reflected in a superbly trained work force, a well-developed industrial and technological base, and a tradition of prudent economic management. The results have been impressive. Between 1960 and 1980, for example, West Germany's per capita income quadrupled, from 4,332 to 18,669 Deutsche Marks (DM's), while GNP expanded five-fold, moving from 303 billion to nearly 1.5 trillion DM's over this period.[4] These achievements form but part of a larger European recovery, made possible through generous grants of U.S. assistance (the Marshall Plan), the erection of a continental-wide marketplace, and promulgation of far-reaching domestic labor (co-determination) and monetary reforms. Of those recipient countries, however, the Federal Republic of Germany seems to have benefitted both itself and its allies the most.

---

[3] *Foreign Policy*, N. 37, Winter 1979-80, p. 179.
[4] *Jahresgutachten*, 1984-85, pp. 274-275.

One of the enduring political facts associated with West Germany's post-World War II emergence has been the remarkable degree of economic consensus which characterizes the policies of conservative-liberal and socialist-liberal governments, i.e., the need for collaborative business-labor relations, investment driven growth, and price stability. What factors explain such cooperation? Recent historical developments, for one thing, namely political instability in the 1920's, followed by totalitarianism, war, physical destruction, and foreign occupation. These experiences gave a powerful stimulus to post-World War II efforts on behalf of all major political parties to adopt consensual, non-ideological policies. Leadership selection has also had a decisive imprint on the shape of post-1945 West Germany economic policies. Breaking with Germany's central European past, Konrad Adenauer negotiated his country's entry into a new partnership with Western Europe by negotiating membership into the European Coal and Steel Community (ECSC) in 1953, followed by its accession to the Treaty of Rome in 1958 which established the European Community (EC). These actions, in turn, facilitated the liberalization of the German economy. It was under Adenauer that West Germany also fashioned equally close trans-Atlantic relations with the United States. The passage of time has brought with it substantial changes in West Germany's international position. But the policy of anchoring West Germany firmly to the Western Alliance remains an enduring legacy of the Adenauer era.

Domestic consensus has been strengthened by the benefits accruing to West Germany as a result of membership in the Western economic order—notably trade driven growth. As a percentage of the country's gross national product (GNP), FRG exports and imports now constitute about a third of it. Indeed, the post-World War II resurgence of West Germany can largely be attributed to the tremendous success of its export policies. Explains West German trade analyst, Michael Kreile: "Export-oriented growth created full employment and prosperity which, in turn, guaranteed popular support for the market economy and the system of democratic institution." [5]

The 40-year economic history of the Federal Republic has not always been tranquil. National division and Soviet efforts to isolate West Berlin from the Western part of Germany contributed to a more generalized feeling of uncertainty which, if anything, was heightened by the first Adenauer government's decision to dismantle the apparatus of controls which governed the economy during the Hitler period. Economic Minister Ludwig Erhard's "early introduction of a social market economy," writes West German economist, Georg H. Keuster, "was experimental, since an open economic system of the sort which the phrase implies was by no means the system desired by the majority of the voters or by the economic experts." [6] Nevertheless, Erhard's gamble paid off handsomely. By the mid-1960's, West Germany had already become the most powerful economy in Western Europe and, next to the United States, the

[5] *Katzenstein*, 1977, p. 192.
[6] Vernon, Raymond, ed., *Big Business and the State*, Harvard, 1974, p. 64.

most influential supporter of a liberal international trade and financial system.

In the 1970's, OPEC price rises and the decline of traditional industrial sectors generated turbulence throughout the capitalist West. Among the industrial market economies, the FRG demonstrated an impressive degree of resilience in bouncing back from these shocks. Its growth rate during the 1975–1980 period compares favorably with the United States (3.5 percent versus 3.4 percent, respectively), while lagging behind Japan's 5.1 percent. On the anti-inflation front, the Federal Republic turned in a more impressive performance than either the United States or Japan.

By the end of the last decade, West Germany found itself in an enviable economic situation. Explains one observer:

> The results were impressive. By 1978, West Germany had emerged as the only major North Atlantic nation to have mastered the OPEC crisis . . . If West German business could no longer afford to make cheap Volkswagen Beetles, it could employ expensive workmanship to make higher value Rabbits. If social benefits were unusually costly, no country looked more stable.[7]

West Germany's rise to economic prominence hardly took place in a vacuum. The United States provided a vital assist in helping West Germany rebuild and prosper at the end of World War II. Domestic recovery, in turn, paved the way for the Federal Republic's entry into the North Atlantic Treaty Organization (NATO) and the European Community (EC).

As Bonn's influence has expanded, so, too, has the expectation on the part of West Germany's partners that it will shoulder a correspondingly larger burden in advancing a larger Western agenda. The FRG has responded by actively engaging itself in areas as diverse as providing aid to southern European democracies and the fledgling Third World countries, to more broadly based multilateral undertakings, designed to improve the performance of the global financial and trade systems. The result is that throughout the 1970's Bonn's influence within Europe, the United States, and many developing countries grew.

Recently, however, West Germany's status as an economic superpower has become more tenuous. This is the message that is conveyed in comparisons of German economic performance between the early 1970's and early 1980's, as reflected in sharp reduction in growth, high unemployment, and vis-a-vis the United States and Japan, the spectre of technological obsolescence.

What has happened? On the international front, Deutsche Mark revaluation, growing stagnation throughout Western Europe, and increased competition from developing countries have had a negative impact on the FRG's economy. These external jolts have been made more severe by the presence of domestic obstacles in the form of relatively high wage costs and tax rates, rigid work rules, an initiative destroying welfare state, along with a variety of outmoded commercial practices which retard innovation and growth.

---

[7] Gibson, *Foreign Policy*, Spring 1982, p. 177.

The most serious economic problem facing West Germany today is unemployment, powered by the erosion of jobs in the FRG's manufacturing sector. The change has been dramatic. Where unemployment stood at a comfortable 3 percent in 1980, it had reached about 9 percent by early 1986. And in larger measure, those ranks of the jobless—in excess of two million people—are the immediate result of two factors: structural rigidities within the labor force that have, in turn, accelerated the replacement of people by machines in the increasingly vulnerable industrial sector.

Gerhard Fels of the Institute for the German Economy (Institute der Deutschen Wirtschaft, IDW) provides the appropriate focus in drawing a negative contrast between the FRG's disappointing job creation record with that of the United States and Japan. "A sectoral breakdown," he maintains, "shows that neither the United States nor Japan had a significant employment cut in manufacturing" over the 1979-83 period, "[while] Germany lost more than two million jobs." [8] Nor is there any indication that improved economic performance as of late will result in significant declines in unemployment. Why not? Structural factors again provide the most immediate explanation. Notably the higher cost of labor in the Federal Republic, vis-a-vis other factors of production. Continues the London Economist: "Between 1973 and 1981, average earnings in West Germany went up by 91 percent, but the user-cost of capital (which includes the prices of plant and machinery, and interest costs) went up by only 62 percent." [9] The result? A powerful incentive on the part of firms to substitute capital for labor even while earnings growth continues to be moderate.

The impact of these factors has been predictable and devastating. In a recent examination of employment trends in 32 West German manufacturing sectors between 1970 and 1981, for example, Klaus-Werner Schatz, another IDW analyst, concludes that "within (these sectors) employment decreased in all but three industries," namely, road vehicle building, aircraft/aerospace, and plastics manufacturing.[10]

Preconditions for Reform

"We don't want more state, but less; we don't want less personal freedom, but more." So declared Chancellor Kohl in the victorious aftermath of the March 1983 election which confirmed his coalition's mandate, initially obtained six months earlier. But what did he mean? A reduction of the state's increasingly authoritative role in the economy, for one thing. To create the necessary preconditions for this development, however, the coalition had to achieve the more immediate goal of restoring financial stability.

In light of its claim on capital, the burgeoning public sector deficit has been a particular source of concern for the government. Up to now, deficit reduction efforts have met with only partial success.

---

[8] Fels, "Changes in Industrial Structure." German-Japanese Seminar, Cologne, September 25-27, 1984, p. 6.

[9] *The Economist*, September 25, 1984, p. 57.

[10] "Demographic and Occupational Shifts Within the Labor Market: The Case of the Federal Republic of Germany," Institute for International Economics: Washington, D.C., November 1984, p. 4.

On the negative side, the OECD reports that "government consumption, after growing less than total public expenditure in 1982/83, expanded faster in 1984 and is projected to continue to do so" in 1985 and 1986—because of jumps in statutory spending by health insurance institutions.[11] Equally troubling is continued heavy reliance on government subsidies to prop up ailing agricultural construction, coal mining, aerospace, shipping, and railway sectors by an avowedly free-market oriented government. The most recent subsidy estimates by the five leading German economic institutes place them as high as DM 110 billion.[12]

On the positive side, the overall deficit of municipal, state, and federal authorities is estimated to have been reduced by nearly $5 billion between 1982 and 1984, moving from $25.05 to $20.75 billion, or 4.4 percent to 3.3 percent of GNP, respectively.[13] Approximately three-quarters of these savings are the result of expenditure restraints, largely brought about through cuts in pension increases and unemployment benefits, with the result that the federal government financed only about 10 percent of the 1985 budget through borrowing, compared with 16.2 percent in 1983.

The upshot? Improved investment prospects in the FRG, as reflected in surging goods orders over the past year in the automotive, clothing, construction, chemical, and capital goods sectors. West Germany's traditional bellwether auto industry, for example, enjoyed a record year in 1985 with production up by more than 20 percent (2.68 million units) in the first seven months. According to the West German Industrial Credit Bank, whose activities include financing medium-sized companies, a new wave of investment is predicted for a number of high-technology sectors, including computer-controlled machine tools, robots, and flexible manufacturing systems.[14]

Two requirements must be fulfilled, however, for the present upturn to continue: reducing the pervasive role of government in the economy while promoting greater flexibility to encourage innovation and growth. These subjects are addressed in the following chapters.

II. Cutting Back Government

Capitalism in post-World War II West Germany has allowed—if not encouraged—a large dose of state intervention. On the surface, this seems surprising in light of the vociferous support for free market doctrines voiced by West German leaders over the past three and one-half decades.

On closer examination, however, German capitalists have traditionally relied upon the state to provide a vital stimulus to business activity. "Paternalistic and authoritarian government intervention in economic affairs is a German tradition that goes back into history," observed Henry C. Wallich three decades ago.[15] In

[11] OECD, *Economic Survey*, June 1985, p. 15.
[12] *Financial Times*, June 6, 1985.
[13] *The Wall Street Journal*, June 9, 1984.
[14] *Financial Times*, September 13, 1985.
[15] *Mainsprings of the German Revival*, New Haven: Yale University Press, 1955, p. 141.

fact, Wallich maintains that Germany's movement toward "a liberal economy after World War II represents a remarkable break with tradition."[16]

West Germany's adherence to those liberal tenets, however, has been strongly qualified by bipartisan political support which has sanctioned government intervention in the private sector. "What was decisive for German economic policies in the 1960's," wrote West German economist Georg H. Kuster in 1974, ". . . was the increasingly direct cooperation among government authorities, organized interest groups, and large enterprises."[17] Such cooperation remains the case today.

Consider tax policy, which over the years has played a vital part in funding subsidy programs. Although he was writing about German practices in the 1950's and 1960's, these remarks by economic historian, Andrew Shonfield, seem no less applicable to West Germany in the 1980's. "Money derived from taxes," he explains, "was needed for a variety of subsidies to support one or another of the activities favored by the states and also to help in the finance of the nation's capital investment at large. Without the massive contribution from public saving, it is doubtful whether Germany would have been able to maintain her exceptionally high level of investment—around 25 percent of the national product in the early 1960's."[18] Investment policy continues to be driven by high levels of tax generated savings. This, in turn, may explain why a 1983 OECD study of eight leading market economies places the Federal Republic just behind Denmark and Sweden among countries which take the biggest percentage bite from single individuals and couples with two children.[19]

In other areas of the West German economy, government involvement is equally pronounced. Many sectors, for instance, are supported by federal, state, and local subsidies, running the gamut from generous allotments for agriculture, shipbuilding, steel, and telecommunications. Another form of assistance involves government support for firms located in geographically disadvantaged areas. This is the case for firms located on the Western side of the intra-German border, and West Berlin—50 percent of whose annual budget is appropriated by the West German Budestag. With regard to West Berlin, however, NATO recognizes that the strategic importance of this city overrides immediate financial considerations.

Outright state ownership of enterprises is also well advanced in West Germany. In 1983, for example, 171 such firms were owned by the federal government "which, in turn, had significant holdings (more than 25 percent of capital and at least DM 100,000) in 386 enterprises."[20] The Kohl government has pledged to reduce subsidization in a number of sectors in order to break the hold of state monopolies that continue to retard innovation while rewarding inefficiencies. Consider the West German postal service which, according to the government's own Monopoly Commission, "has re-

---

[16] *Ibid.*, p. 141.
[17] *Big Business and the State*, Cambridge: Massachusetts, 1974, p. 83.
[18] *Modern Capitalism*, London: Oxford University Press, 1969, p. 266.
[19] OECD Economic Surveys 1984-85, Germany, Paris, June 1985, p. 32.
[20] OECD 1984-85, "Germany," p. 33.

duced the variety of supply considerably, weakened the technological base of German industry in the area and led to a conservation of supply structures." [21]

The case against further subsidization is a powerful one. Contends Ernst Juergen Horn, an economist at the Institute for World Economics in Kiel, West Germany:

> According to the philosophy widely accepted in the Federal Republic of Germany, production of goods and services should be organized by private individuals in free markets. In this way, production could meet consumer preferences efficiently. This philosophy is hardly compatible with the existence of state owned enterprises, at least where these enterprises compete with private firms in the market. Nevertheless, public enterprises exist and, taken together, form a sector of considerable size in the economy.[22]

In the Federal Republic, state-run enterprises enjoy monopoly positions in the following sectors: public utilities, railways, urban mass transit, airlines, and communications. Consider once again the 400,000 person strong West German Bundespost which is the country's largest employer and investor.[23] Placed under the direct authority of the country's Post Ministry, the Bundespost's existence is guaranteed under West Germany's constitution. Not only are its prices considerably higher than those charged by comparable private sector communications firms in Western Europe, but the Post's monopoly position discourages it from employing the most up-to-date telecommunications equipment. A government-sponsored Commission is examining prospects for major reforms "especially concerning licensing of new office and household devices."[24] The future power of the Ministry, however, is not being placed in question.

Despite the Kohl government's commitment to sell off a number of state-supported enterprises, the record has been disappointing. In June of 1985, the Federal Ministry of Economics announced its intention to reduce state subsidies in 1986 by about 1 billion DM, with shipyards, steel, coal mining, and aerospace sectors expected to absorb the bulk of these cuts.[25] But, as with every other previous government, political pressures will probably frustrate what seem to be, at best, half-hearted efforts. Indeed, since coming to power the coalition can point to but one instance where the state's role in industry has been reduced, namely, the huge conglomerate of VEBA-AB whose public assets were reduced from 43.4 to 30 percent.

Formidable political obstacles explain why the government's privatization initiatives have up to now been stillborn. Ties between corporate and state enterprise are well-developed by the Federal Republic. Far from being antagonistic, private and public sector bureaucracies support each other. The giant electronics company of

---

[21] *Ibid.*, p. 33.
[22] Horn, Ernst Juergen, Management of Industrial Change in Germany, Sussex University Research Center, 1982, pp. 28-29.
[23] *Financial Times*, July 11, 1985.
[24] *The Wall Street Journal*, October 24, 1985.
[25] *Financial Times*, June 6, 1985.

Siemens personifies this special link. For the year ending September 30, 1984, alone, it obtained about $1.7 billion from government agencies.[26] Many West German corporations would, accordingly, suffer major financial losses in the event government subsidies were eliminated or substantially cut. These anxieties may, in turn, explain why Bavarian political leader, Franz Josef Strauss, informed the Chancellor last year that he and his south German supporters were opposed to even the partial privatization of Lufthansa Airlines. The lesson behind such political interventions is that future hopes for meaningful subsidy reductions in the FGR must be based on an effective—politically persuasive—adjustment strategy for a diverse number of industries which continue to require subsidies for their very existence even as they become increasingly less competitive.

III. Creating Incentives

"Within the European Community, the time has clearly passed when individual members could pursue their own autonomous economic policy," writes former West German Chancellor Helmut Schmidt.[27] This reality applies with special relevance to the Federal Republic which, since 1949, has attempted to overcome national division by making integration with Western Europe a cornerstone of both domestic and foreign policy. As a founding member of the European Community (EC), the vast bulk of West Germany export earnings derive from trade with its immediate neighbors. For the first half of 1985, West German exports to its top five markets reached 128 billion DM, nearly 80 percent of which went to EC countries.[28] In a similar vein, the conduct of Germany's monetary policy—notably the exchange rate of the Deutsche Mark—is intimately tied in with the operation of the European Monetary System.

Nevertheless, as the most powerful, bellwether economy in Western Europe, the Federal Republic exercises considerable control over its own economic fortunes. Wages, unemployment compensation, regulation, decisions on taxes, investment, research and development, and the creation of market incentives—decisions in these matters lie within the direct competence of the German government and business community.

Proponents of reform are calling for far-reaching changes in the operation of the domestic economy in a number of areas. Consider, for example, the problem of market "inflexibility." Explains Klaus-Werner Schatz, an economist with the Institute for the World Economy in Kiel:

> Germany suffers from a lack of flexibility which is neither due to challenges which would be totally unknown to the country—the challenges to meet in the 1950's or 1960's were much more important—nor due to loss of work ethics. The problem is that the incentives to individuals are hardly conducive to meet the challenges, may the indi-

---

[26] *The Wall Street Journal*, October 10, 1985.
[27] die Zeit, September 13, 1985.
[28] die Zeit, September 11, 1985.

viduals be entrepreneurs, may they be employed. Those who want to work harder to qualify, to be flexible, are taxed too hard; they suffer also from too small differences in wage and salary incomes. With the low profitability of investment, taking entrepreneurial risk does not pay. Also, Germany knows too much regulation and barriers to entry which prevents the economy from adjustment.[29]

Among the most commonly cited regidities are those involving:

Employment Costs

In its 1985 survey of the West German economy, the OECD compares wage rigidities between economies and the rise of unemployment. "Germany," it concludes, "is shown to have combined a comparatively high degree of 'real wage rigidity' and a strong rise in 'structural' unemployment." [30] The result is that even during periods of moderate expansion, such as the present, unemployment in many sectors of the economy promises to remain high; notably so in manufacturing where labor contracts are largely responsible for keeping employment costs high even during periods of declining demand and industrial contraction. While significant productivity gains have been registered throughout the West German economy over the past decade, these gains are largely found in labor saving devices which firms are increasingly resorting to as a way of reducing excessive employment costs. Unless the economy is able to devise a more flexible wage structure, the movement toward substituting capital over labor promises to continue.

By international standards, labor costs in the Federal Republic of Germany are quite high. This is a result of rising nonwage costs, which have grown from about 42 percent of regular hourly wages in industry 25 years ago to 77 percent in 1981. For 1981, social security contributions alone took up to 36.5 percent of hourly wages, while vacation and various bonus payments, respectively, claimed 20.5 percent and 15.5 percent of those wages.

Social Regulations

West Germany's unemployment level of more than 9 percent represents the highest rate of joblessness in the history of the country. To be sure, some of it is the result of recessionary conditions throughout the European Community's system of interdependent markets. But some of West Germany's unemployment can be traced to the impact of social regulations. Enterprises, for instance, are subject to legal restraints during layoffs when the number of employees (excluding trainees) reaches six. When this number hits 21, the firm becomes subject to a mandatory "social plan" which substantially raises the cost of such layoffs. It also provides a major incentive to reduce hirings during cyclical upturns. Comments University of Kiel economist Klaus-Werner Schatz: "In manufacturing, wage costs to employers have risen by 104 percent between 1972

[29] *Ibid*, p. 36.
[30] *Ibid*., pp. 38-39.

and 1981—half of which is due to costs which employers have to bear in addition to gross work pay." [31]

Market Rigidities

Rigidities within the domestic marketplace pose troubling questions for a Germany which must devise even more flexible responses to the competitive challenges of the 1980's. The country possesses ample reserves of entrepreneurship and quality workmanship. But in a number of instances, these potentials are frustrated by a myriad number of barriers. Consider, for example, those which discourage entrepreneurship. Assuming there is a job opening, entry into one of the nation's large, well-established firms is relatively easy. Not so, however, for those individuals who want to start a business from scratch. To help remove such obstacles, the federal government has set up a $270 million venture capital program to channel private funds to smaller business. Considerable amounts of money are likewise being made available by state governments to promote business formation, notably in Bavaria and Baden Wuerrtemberg. But significant barriers to starting up new businesses continue to persist, notably prohibitions governing the hours when shops may operate; licensing requirements which strictly control entry into an array of service industries; and more broadly, the absence of essential business skills which people need if they are to compete successfully in the marketplace.

IV. International Aspects of West German Renewal

West Germany's economic revival has important implications for its Japanese, European, and American allies. As the United States sees it, the Federal Republic's sheer economic muscle casts it as the natural leader after the United States in leading the world toward recovery. It is the holder of the world's largest monetary reserves, and consistently runs large trade surpluses. Moreover, West Germany and the United States hold similar views on international economic policy. The FRG, for example, has loudly echoed President Reagan's call for freer international trade. Sigfried Mann, executive secretary of the influential Confederation of German Industry, recently warned a group of Common Market officials: "whoever wants open markets abroad for his own products should not at the same time want protection at home." The White House could not have said it better.

West Germany's prime asset remains the sheer volume of trade-driven growth it generates for itself and the world. In terms of gross national product, West Germany is one-fifth the size of the United States. But as of 1984, its trade volume, exports plus imports, is half of the United States' total, making West Germany the world's second largest trading country. Bonn's trade with the world expanded by 12 percent in 1984 and included a 15 percent increase in trade with the Third World, which came to $24 billion. Thanks to the strong dollar, West Germany exports to the United States jumped by 43 percent in 1984, generating about one-third of its $20

---

[31] "Demographic and Occpational Shifts Within the Labor Market," Kiel, November 1984, p. 34.

billion surplus. 1985's surplus could reach $24 billion. That trading makes West Germany, as opposed to France or Italy, uniquely qualified to give the world economy a shot in the arm by promoting expanded imports from Third World Countries while, more broadly, supporting U.S. effforts to dismantle global barriers to trade.

In light of these international realities, Bonn's allies have compelling reason to hope for more expansive West German economic policies in the form of accelerated tax cuts and more relaxed monetary policies designed to lower interest rates. The United States was under the impression that it had obtained West German agreement to undertake such steps in late September 1985, when Bonn and the other Group of Five Countries appeared to accept Washington's argument that it needed to pursue economic expansion more vigorously in exchange for a coordinated, if still undefined, effort to reduce the value of the dollar. An initial step in the right direction would be implementation of the second, $3.4 billion phase of the government's $7.7 billion personal income tax reduction package, one year ahead of schedule. In October, in a rare display of solidarity, the five senior economic research institutes advised Mr. Kohl's cabinet to take just that step. These calls for more stimulatory initiatives were echoed this spring by the IMF in its annual "World Economic Outlook."

But West Germany continues to hesitate. Since the spring of 1985, Finance Minister Gerhard Stoltenberg has been sending the same message: "The risks of such actions would be likely to outweigh the prospect benefits." Bonn, in short, seems intent on ignoring U.S. calls for more expansive economic policies while concentrating instead of budget-cutting and price stability. In this, the ruling conservative/liberal coalition is no different from its socialist/liberal predecessor. But the matter cannot be left here. Like it or not, both the Congress and the Reagan Administration have a strong incentive to continue the dialogue with Bonn in the hope that over time the two partners can agree on at least a minimal consensus program designed to encourage West Germany to take a more active economic role. Three major components of that program involve the following:

1. Domestic growth: Within the realm of the possible, the Federal Republic should be encouraged to continue—if not accelerate—the modest supply-side initiatives which have been undertaken over the past several years. Inflation is well under control. Likewise, the government has made substantial progress in cutting the budget deficit. The last major domestic hurdle facing the coalition—unemployment—remains to be tackled, however. At this juncture, further liberalization of the domestic economy would reduce unemployment at home while providing a badly needed stimulus for market reforms throughout the European Community.

2. Expanded trade with the Third World: Compared with the United States, West Germany's trade with developing countries is exceedingly small. In 1984, for example, the total volume of trade between the FRG and these areas came to but $30 billion, with West Germany running a modest deficit of about $1 billion. As the dollar weakens, one must expect a corresponding drop-off in Third World exports to the United

States—and a complementary effort by these countries to make up for declining earnings in other industrial country markets. As Western Europe's largest and most dynamic economy, the FRG should be encouraged to undertake substantial efforts to boost imports of goods from Africa, Asia, and Latin America.

3. Policy coordination with the United States: Washington and Bonn do not always agree. But their disagreements should not provide a rationale for inaction. On a number of fronts, running the gamut from a closer coordination of the $-DM exchange rate to the promotion of a new multilateral trade round, German and American leaders share congruent perspectives on what the industrial West needs to do to enhance prospects for future global stability and growth. The time has arrived for both countries to put these perspectives to work on behalf of a common cause.

O