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RESTORING INTERNATIONAL BALANCE: THE FEDERAL REPUBLIC OF GERMANY AND WORLD ECONOMIC GROWTH

A STAFF STUDY

PREPARED FOR THE USE OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

JUNE 2, 1988

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LETTER OF TRANSMITTAL

JUNE 1, 1988.

To the Members of the Joint Economic Committee:

I am pleased to transmit to you the second in a series of studies by Joint Economic Committee staff members which focus on the trade surplus phenomenon, and the problems which today's unprecedented trade surpluses pose for the world trading system and, over time, for the countries that hold them.

The decision to undertake these studies reflects the Committee's concern that the huge and growing imbalances in international trade flows constitute a serious threat to the health of the world economy. Some countries, particularly the United States, are posting unprecedented trade and current account deficits. Others, notably Japan, the Federal Republic of Germany, Taiwan, and South Korea, are running up trade and current account surpluses of comparable significance. Over the long run, these imbalances cannot be sustained. The longer they continue, the greater the danger that markets will impose a correction in the form of a sharp and wrenching world recession.

Much of the discussion of world trade imbalances has focused on the adjustment tasks facing deficit countries. The Joint Economic Committee has contributed to the discussion, most recently with the August 1987 study, "The Legacy of Foreign Debt," and in a number of earlier studies and reports. As the world's largest debtor nation, the United States has been the focus of much of this discussion, and it is clear that decisive changes are needed in the mix of U.S. policies to increase the ability of U.S. producers to compete both abroad and at home. This study is in no way intended to minimize the gravity of the U.S. trade deficit, or to minimize the complexity of the challenge we face in attempting to reduce the deficit.

However, the task of remedying global imbalances does not rest exclusively with the world's deficit countries. A more balanced international trading system will also require policy modifications on the part of countries with large trade and current account surpluses. While from the perspective of an individual country surpluses may seem desirable, the benefits will continue to accrue only in the short term. When large surpluses—and deficits—persist in the world trading system, they pose a serious threat to the functioning of the system as a whole. In the long term, the prosperity of all trading nations depends on the successful functioning of this system.

The JEC's studies of the world's major surplus economies are designed to explore the causes of surplus and the policy alternatives for addressing them. They start from a premise that sharp recession in any country is a costly and undesirable solution to the problem of imbalance, for surplus and deficit nations alike. Their purpose is to provide a better understanding of the surplus phenomenon, thereby contributing to economic policies directed to assuring orderly reductions in world trading imbalances and minimizing the risk of world recession.

The sources of surplus are rooted in particular institutions and practices which vary from economy to economy, and therefore these studies are organized on a case-by-case basis. The first in the series focused on Taiwan, the trading nation with the highest ratio of current account surplus to GNP. This second study focuses on the Federal Republic of Germany, the nation with the highest level of exports. Subsequent studies will explore the other major surplus countries: Japan and South Korea.

The series is a collaborative effort among the international economists of the Committee staff who extensively review each study prior to release. This second study was written by Dr. Daniel L. Bond, Senior Economist on the staff of the Joint Economic Committee.

It is my hope that these studies will prove useful to you in analyzing the changes taking place in the world economy.

Sincerely,

PAUL S. SARBANES,
Chairman.

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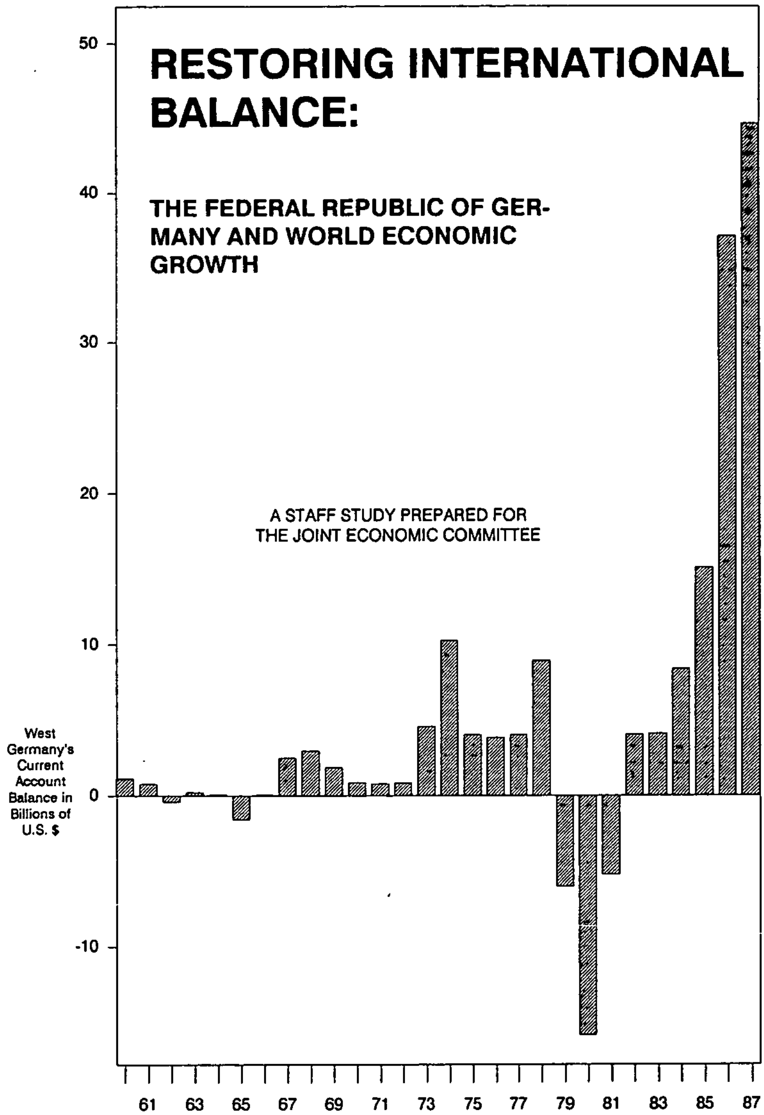
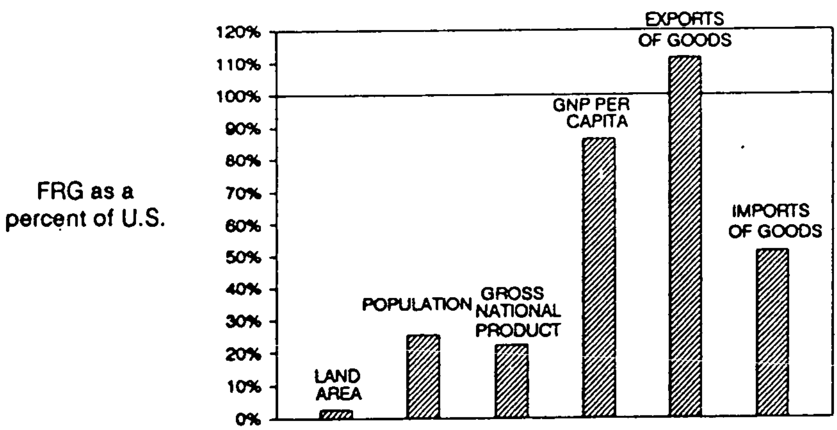


INTRODUCTION

The Federal Republic of Germany (FRG) is the world's leading exporter even though it is a country with less than 5 percent of the land area, one-fourth the population, and 22 percent of the output of the United States (see Figure 1). Statistics published by the Organization for Economic Cooperation and Development (OECD) show that the FRG's exports of goods in 1987 had a total value of $294 billion, compared to exports of approximately $253 billion by the United States and $231 billion by Japan. Since 1985 the FRG has exported more than the United States—and outstripped the United States in the export of manufactured goods by a third. At the same time, the FRG has imported only half as much as the United States.

FIGURE 1

THE FRG & US ECONOMIES COMPARED (1986)

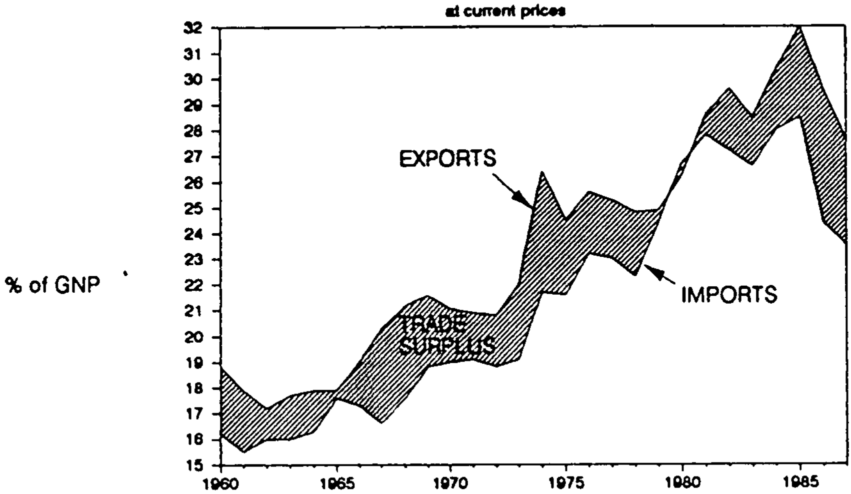


The wide disparity between exports and imports has led to trade surpluses averaging 4 percent of gross national product (GNP) over the past six years (see Figure 2). These surpluses are a significant factor in the current imbalances in global commerce, imbalances that contribute to trade frictions and to volatility in the financial markets, and pose serious obstacles to world economic growth.

FIGURE 2

TRADE IN GOODS & SERVICES

at current prices



The FRG's trade surpluses reflect the lagging rate of expansion in the German economy, which was only 1.7 percent in 1987 and is expected to be less than 2 percent in 1988 and 1989.[1] The slowdown has severe implications for world economic growth, for the Federal Republic's potential contribution is much greater than is commonly perceived. The Federal Republic accounts for roughly 6 percent of world GNP, compared to Japan's 10 percent and the United States' 23 percent. But the FRG plays the pivotal role in the economy of Europe, a region producing roughly 30 percent of world output. The current slowdown in the FRG economy tends to retard growth across Europe and contributes to the economic difficulties of the rest of the world.

This study will examine recent economic policy and performance in the Federal Republic, focusing on the problems associated with the country's large trade surpluses. Since the surpluses cannot be sustained indefinitely, some adjustment in the economy of the FRG is inevitable, and the study will consider possible adjustment policies for the medium and long term. At the present time, the slowdown of activity in the private sector suggests the need for such government actions as increased public investment, tax cuts, and a more expansionary monetary policy. Over the long term, the need for global balance will require: (*a*) within the Atlantic Alliance, an effort to find new ways to share the economic costs of the North Atlantic Treaty Organization (NATO) defense; and (*b*) in the broader international community, an effort to assure growth in the developing economies of the Third World.

[1] International Monetary Fund, *World Economic Outlook,* April 1988.

BACKGROUND TO THE CURRENT DEBATE

During the 1980's economic relations among major countries and regions of the world have become increasingly out of balance. In the view of the International Monetary Fund (IMF):

> The continuing widening of current account imbalances, particularly among the three largest industrial countries—the United States, Japan, and the Federal Republic of Germany—has become a subject of increasing concern. Because of the threat of protectionism and the risk of financial market unrest, these imbalances are potentially destabilizing, with serious implications for growth throughout the world economy if they were to persist over an extended period of time.[1]

The trade and current account surpluses of the Federal Republic of Germany, as well as those of Japan, have risen rapidly since 1981, while U.S. external balances have plunged into large deficits (see Figure 3). Both the size of the resulting imbalances and their persistence over time are without recent historical parallel and, in a period of only a few years, the United States has gone from being the world's leading creditor to being the world's largest debtor. Much of the U.S. debt is owed to Japan and the FRG, whose combined net assets have risen by an equivalent of two-thirds of the decline in U.S. net assets (see Figure 4).

[1] International Monetary Fund, *Annual Report*, 1987, p. 1.

FIGURE 3

CURRENT ACCOUNT BALANCE

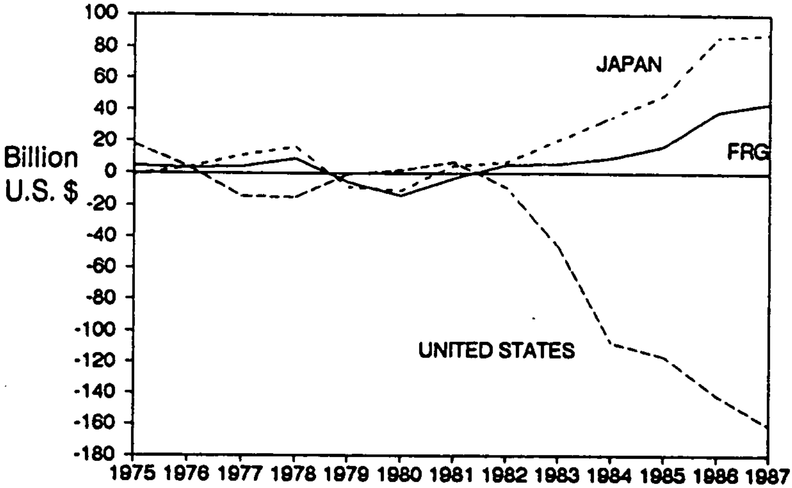
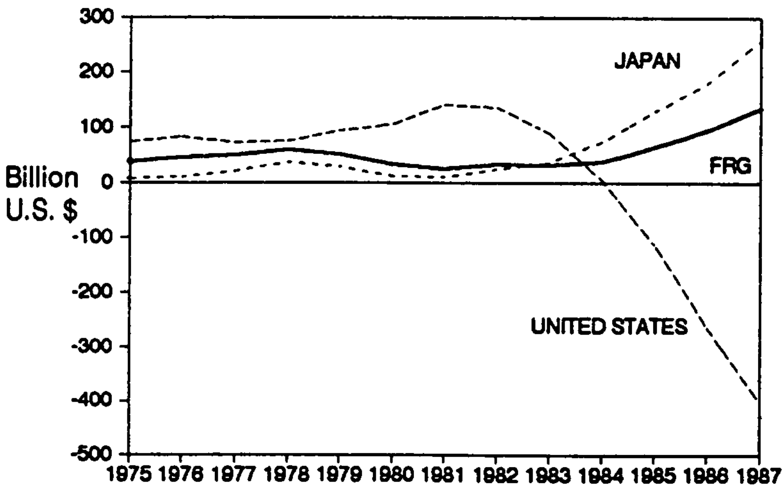


FIGURE 4

NET INTERNATIONAL INVESTMENT POSITION



Given the FRG's 1987 merchandise trade surplus of $70 billion and foreign exchange reserves of over $75 billion, it is not surprising to find a widespread conviction, inside the Federal Republic and in other countries, that the FRG has a major role to play in reducing global trade imbalances. The FRG is being strongly urged from many corners to stimulate domestic economic growth in order to raise the level of imports and reduce the country's trade surplus.

The FRG's reliance on exports as its primary source of growth is reflected in the recent unexpectedly poor performance of the FRG economy in the face of the falling value of the dollar and contracting export markets. After three years of expansion of real GNP at annual rates of 2.4 to 3 percent, the economy slowed to an estimated 1.7 percent increase in GNP during 1987. The outlook for 1988, given current government policies, is little better. The OECD projection is for ". . . subpotential economic growth, persistently high unemployment and a still sizable current external account surplus which is clearly unsatisfactory from the domestic as well as the international point of view." [2]

One of the major challenges facing the Federal Republic is how to adjust to the changing relationship between the deutsche mark (DM) and the dollar (see Figure 5). The dollar's appreciation in the first half of the 1980's accounted for much of the FRG's growing trade surplus with the United States (see Figure 6); this in turn accounted for almost half of the ecomomy's growth in this period. The effect of the DM's recent appreciation has been to erode the price competitiveness of FRG products relative to those of Germany's major competitors (Japan being the major exception), leading to recent stagnation in the volume of exports.

[2] OECD, *Economic Survey, Germany,* 1987, p. 61.

FIGURE 5

NOMINAL DEUTSCHE MARK EXCHANGE RATE

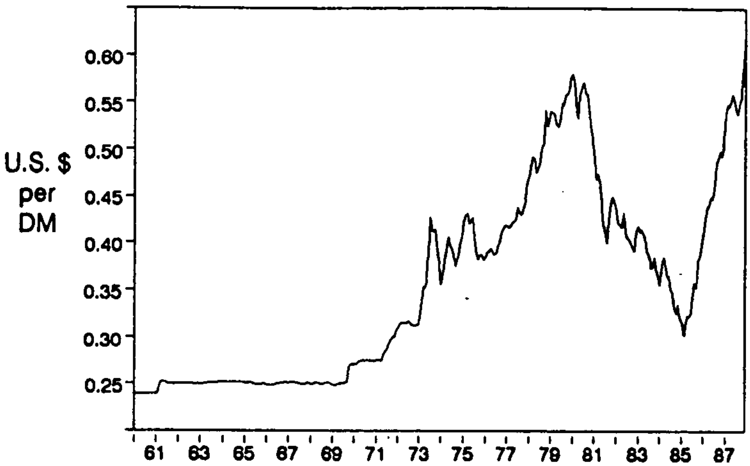
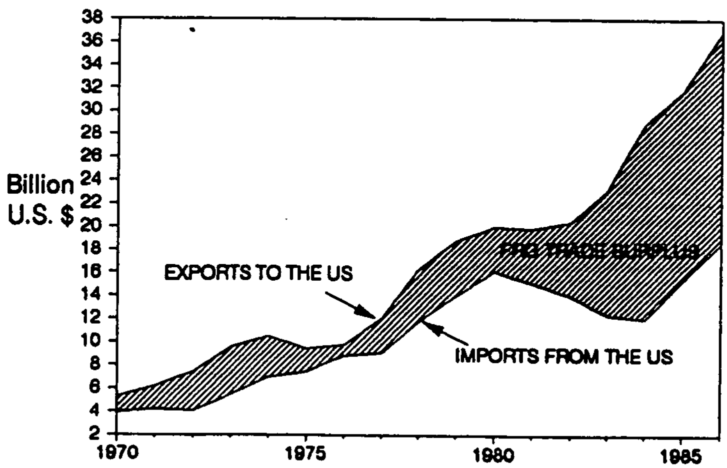


FIGURE 6

FRG TRADE IN GOODS AND SERVICES WITH THE US



The European Context

Since the FRG is the linchpin for Europe its rate of growth by and large determines growth rates for the entire region, stimulating or holding back other national economies. Most European countries share with the Federal Republic the problems of slow growth and high unemployment. Real GNP growth in the 12 countries of the European Community (EC) was an estimated 2.2 percent in 1987, and unemployment was near 12 percent of the civilian labor force; 16 million people were officially out of work.[3] [4]

A number of factors suggest that Europe is today in an unprecedented position from which to launch a coordinated growth strategy. Inflation rates are low; unemployment rates are high; and rates of return on capital have risen significantly from their depressed levels following the oil price shocks of the 1970's. While some countries have relatively high levels of public sector indebtedness, in almost every country the rate of government borrowing has stabilized or declined in the last few years, and in fact the major obstacle at this time to continued budget consolidation is the slowdown in growth that has accompanied the reductions in Europe's trade balances.

The appreciation of European currencies against the dollar is likely to cost the region even more growth unless new sources of internal demand materialize. As in the FRG, the hoped-for spontaneous growth of private consumption and investment has failed to appear. In the absence of such additional private sector demand, there is a need for government action, ideally on a European-wide basis. The Commission of the European Communities, in its latest report, points out the importance of a coordinated strategy in Europe:

> Because of the ever-closer economic ties, the flows of goods and finance react more rapidly, and this increasingly reduces the autonomy of individual Member States in the conduct of their economic policy. The close economic ties, however, also provide new opportunities for joint action and increase the Community's potential for growth, provided that economic policy measures are more closely coordinated.[5]

While in international communiques the emphasis must be on coordination, in reality the Federal Republic must play a leading role. As the strongest economy in Europe, the FRG's policies can either pull the other economies in the region ahead, or hold them back.

A more expansionary policy in the FRG could facilitate adoption of similar policies elsewhere in Europe, thereby magnifying the growth and trade effects. Trade interdependence means that tax cuts or additional public investment in the FRG eases the con-

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[3] The unemployment rates used in this report are given as a percent of the total labor force and are estimated by the OECD on a standardized basis to facilitiate international comparisons. Unemployment rates estimated and published by the U.S. Bureau of Labor Statistics for the European economies are somewhat lower.

[4] The current members of the EC are Belgium, Denmark, France, the FRG, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, and the United Kingdom.

[5] Commission of the European Communities, *Annual Economic Report 1987-1988, 1987, p. 34.*

straints on similar measures elsewhere in Europe. Faster growth in the FRG means increased exports, jobs, and growth among its trade partners, allowing the governments in those countries to take steps to stimulate their own economies. In the interdependent European system some of this growth will, in turn, be returned to the FRG through increased demand for German products.

The deutsche mark plays such an important role in the European Monetary System (EMS) [6] that most other European countries can lower their interest rates only after the FRG has done so. If other EMS members attempt to lower their rates ahead of the FRG, they will almost immediately face outflows of capital, downward pressure on their currencies, and increased inflation, all tending eventually to force their interest rates back up. When the FRG relaxes its monetary policy, however, interest rates throughout the EMS can be lowered. Once again, the secondary impacts of such a move by the other countries would help alleviate the problems that concern policymakers in the FRG.

FRG officials often point out, when urged to make their economy a "locomotive" for the world, that the FRG's economy is only one-quarter the size of the United States and represents roughly 6 percent of the world output, thereby suggesting that any reasonable increase in the FRG's growth rates would have but minor impact on either the United States or world economy. But this argument appears to assume that a more stimulative policy in the FRG would be taken in isolation. It overlooks the fact that, in terms of the FRG's potential contribution to global growth, the FRG occupies the economic leadership role within Europe. The relevant comparisons then shift dramatically: Europe's GNP is greater than that of the United States, three times that of Japan, and represents roughly 30 percent of world output.

If Europe's momentum is to help pull the world economy ahead, much will depend, of course, on the policy response in the rest of the world. But it is difficult to see how substantial world economic growth can be achieved without a revival of domestic demand and imports in Europe.

The U.S. Perspective

Conditions in the U.S. economy during the 1980's have, in important respects, been the reverse of those in the FRG. A dramatic rise in the foreign exchange value of the dollar reduced the price competitiveness of U.S. exports and made foreign products less expensive for the American consumer. Given strong growth in domestic demand during the 1983–84 recovery, imports increased much more rapidly than exports, leading to an even sharper rise in the U.S. trade deficit.

Restoration of more balanced trade between the United States and the rest of the world via depreciation of the dollar on foreign exchange markets was forestalled for several years by large inflows of foreign capital, attracted to the United States by relatively high interest rates and an expanding economy. In 1985 the U.S. Treasury began taking steps to bring down the foreign exchange value of

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[6] The members of the European Monetary System are: the FRG, France, Italy, Belgium, the Netherlands, Luxembourg, Ireland, and Denmark.

the dollar, including a return to government intervention in foreign exchange markets (in coordination with the central banks of the FRG, Japan, France, and the United Kingdom) and working with the Federal Reserve to lower interest rates. At the same time spokesmen for the U.S. Administration began urging Japan and the Federal Republic to take steps to stimulate growth in their economies in order to increase demand for U.S. products.

The adjustments in trade underway in the FRG and the United States are not separate processes. Each is a major trading partner of the other. In 1986 trade between them, exports plus imports, was $55 billion, with the U.S. bilateral trade deficit amounting to $18 billion. The economic bond between the United States and the FRG has been strengthened in recent years by the integration of their capital markets. Changes in interest rates or business prospects in either country quickly lead to movement of capital between the two. Close coordination and cooperation between the two countries in the choice of economic policy measures therefore appear to be highly desirable.

While the appreciation of the DM relative to the dollar since 1985 has begun to reduce the trade imbalance between the United States and the FRG, the recent slowdown in domestic growth in the FRG economy poses an obstacle to further reductions.

The implications for the United States of the Federal Republic's economic slowdown are magnified by the European context. In 1986 total trade between the United States and the West European countries other than the Federal Republic was $210 billion, with the U.S. trade deficit amounting to another $18 billion (matching the $18 billion trade deficit with the FRG). To the degree that slower growth in the FRG holds back growth in other European countries, reductions in this trade deficit are also jeopardized.

The global adjustment process is complicated by the fact that corrections on financial and foreign exchange markets appear to move at a much faster pace than the real economies can accommodate. In the FRG, domestic demand has been growing too slowly to take up the slack created by the loss of exports; conversely in the United States, demand in some sectors is so high that capacity constraints are keeping producers from responding to all the export opportunities created by a declining dollar.

Even under the most favorable conditions smooth adjustment would be difficult to achieve. It takes time to retool productive capacity to meet the needs of different markets, since the mix of products a country consumes domestically and those it trades abroad differ; and business decisionmakers must adjust to new situations. Adjustments also necessitates reassessment and change in government policy. This is a difficult process in the best of circumstances, and it is especially challenging given the FRG's economic history. The remainder of this report focuses on the adjustment question.

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PRECEDENTS TO CURRENT POLICY

The current debate over FRG economic policy can perhaps best be understood by looking at certain aspects of the FRG's economic history in the postwar period. Events during the past four decades have left the FRG with:

- A preference for fixed medium-term policy and an aversion to cyclical intervention;
- A bias toward export-led growth; and
- A cautious attitude toward international economic policy coordination.

FIXED POLICY VERSUS CYCLICAL INTERVENTION

Over the past century the German economy has gone through several cycles of dramatic growth, hyperinflation, and depression. This great instability was due not only to the impact of two major wars, but also to fiscal and monetary policies followed by the government. Following World War II one of the most important economic tasks facing the country was to rebuild confidence in the currency through monetary and fiscal reforms.

The "Basic Law" of 1949 established the political framework for the Federal Republic, a 10-state federal system with three major policymaking institutions at the national level—the parliament or Bundestag; the Federal Council, or Bundesrat; and the federal executive, consisting of the chancellor and his cabinet. The Basic Law gives the 10 states (or Länder) considerable control over local affairs and direct influence at the federal level through their representation in the Bundesrat.[1] The local governments, at the county and municipal levels, make up the third level of the system. Whatever economic policies the federal government wishes to pursue must be closely coordinated with the Länder, since the latter account for almost as much revenue, spending, and borrowing as the federal government. (With a number of the Länder always controlled by opposition parties, this task can be difficult.)

In the Federal Republic all major political decisions are made by the parties and their representatives. During most of the postwar period there have been two major political parties, the Christian Democratic Union (CDU) with its Bavarian affiliate, the Christian Social Union (CSU), and the Social Democratic Party (SPD), plus one smaller party, the Free Democratic Party (FDP). The CDU and CSU controlled the federal level of government from 1949 to 1966. In the 1966–1969 period they formed a "grand coalition" with the major opposition party, the SPD. Subsequently the SPD made an alliance with the FDP, governing during 1969–82. In 1982 the CDU/CSU returned to power in a coalition with the FDP. This coa-

[1] West Berlin is often counted as the eleventh Lände, but juridically it has a different status.

lition carried the 1987 election, and it is expected to continue in power until at least 1990.

Despite changes in party leadership, since the late 1950's there has been a substantial degree of agreement on, and continuity in, government economic policies. The economic approach supported by all the major political parties has been that of the "social market" (Soziale Marktwirtschaft), emphasizing the benefits of a self-regulating free market underpinned by a strong social support system. In theory the government's role has been to ensure the economic institutions and rules necessary for the market to function properly. Nonetheless, the government has remained actively involved in the economy, especially through labor market and industrial policies, and a significant degree of government ownership of business in specific sectors, such as iron, steel, coal mining, shipbuilding, and nuclear energy.

As to economic stabilization, prior to 1967 the government's attention was directed above all to monetary policy. In large part this was because until 1967 the governmental faced severe legal restrictions on the use of budget deficits in formulating fiscal policy. Thus almost all the government's instruments for stabilizing business cycles were in the hands of the central bank, or Bundesbank, which controls monetary policy.

The Bundesbank has consistently focused on assuring price stability rather than on addressing problems of unemployment. The sources of this emphasis are historical.

> The trauma of two big inflations—the hyperinflation of the early 1920's and the repressed inflation of the early 1940's—left contemporary Germans with a deep-seated fear of even marginal rises in the price index. The currency reforms in 1923 and 1948 destroyed almost all financial wealth. Thus two successive generations of Germans suffered dramatically from inflationary policies. The experience created a lasting, determined preference for an anti-inflationary policy and shaped the form of the present economic system which possesses institutional mechanisms to prevent inflation.[2]

Legally the Bundesbank sets it policy independently of the federal government, although it is bound to support the government's overall economic policy as long as this is consistent with its mandate of "regulating the money circulation and the supply of credit to the economy with the aim of safeguarding the currency."

During the 1950's and the first half of the 1960's there were no recessions in the Federal Republic, economic fluctations were mild, and there was a steady decline in unemployment. The first major setback in the economy came in 1966–67. Tight Bundesbank policy in 1966 resulted in inadequate money supply expansion and an upsurge in interest rates. The government found itself incapable of quickly counteracting the ensuing drop in domestic demand. Real GNP, which had been increasing at an average rate of 5.5 percent

[2] Norbert Walter, *West Germany's Economy: Origins, Problems, and Perspectives*, The American Institute for Contemporary German Studies, 1987, pp. 11–12.

in the first half of the decade, suddenly dropped to only 2.9 percent in 1966 and then declined by 0.1 percent in 1967.

In response to the economic downturn a "Law to Promote Stability and Growth" was passed in 1967. It directed the federal and state governments to pursue policies directed at the following four macroeconomic goals:

- Economic growth (see Figure 7);
- Price stability (see Figure 8);
- Full employment (see Figure 9); and
- Balance-of-payments equilibrium (see Figure 10).

FIGURE 7

GROSS NATIONAL PRODUCT

at constant market prices

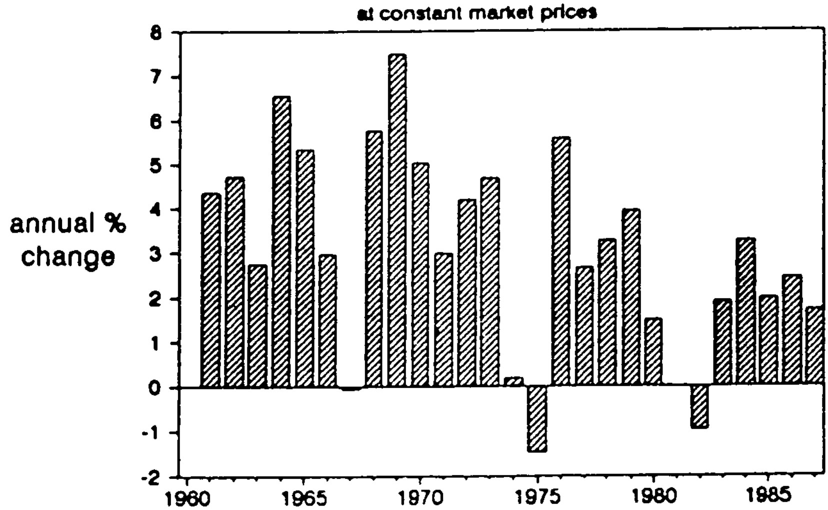


FIGURE 8

GNP DEFLATOR

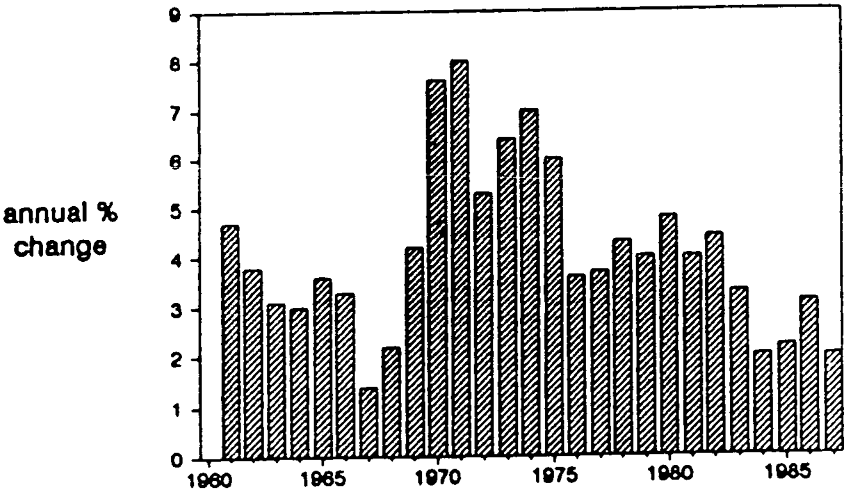
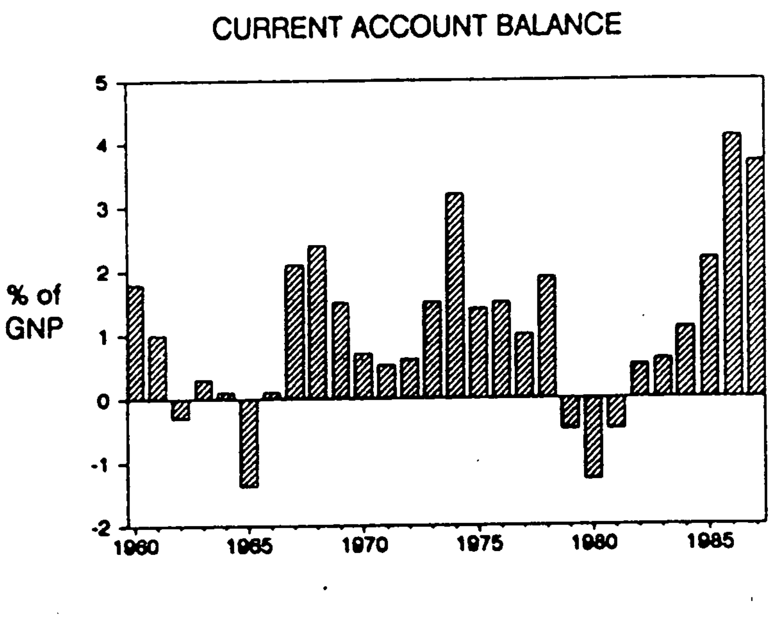


FIGURE 9

FIGURE 10



Together with economic and financial planning procedures that were introduced in the Finance Reform of 1969, the Law to Promote Stability and Growth gave the federal government its first significant power to pursue countercyclical policies. The Basic Law was modified to allow the federal government to borrow up to the officially designated level of investment expenditures and, in periods of economic necessity, this limit could be exceeded. In addition, the federal government was given the right to raise or lower personal and corporate income tax rates by 10 percent (for a maximum duration of one year) as needed to constrain or stimulate the economy. To facilitate the use of these tax cuts for anticyclical purposes, the Act stipulates that they can be enacted without advance approval by the parliament.[3]

To strengthen the coordination of budgets among the various levels of government, intergovernmental planning groups were established and the federal government was given increased authority to provide grants-in-aid to the Länder for the purpose of countercyclical policy. These were attempts to involve the lower levels of government more actively into the process of macroeconomic management, a much-needed change since the federal government's anticyclical efforts could be offset by the budgetary actions of the Länder and local governments, which together control a larger share of the total public budget than does the federal government.[4]

The government responded to the 1966–67 recession with increased government spending, tax reduction, and lower interest rates, and by 1969 the economy was restored to health. When the economy was struck by its next recession in 1974–75—a recession brought on by the slowdown in world trade and economic activity resulting from the first Organization of Petroleum Exporting Countries (OPEC) oil price shock—the government responded with a sharp increase in spending (see Figure 11), in large part a response to the rapidly rising level of unemployment. Growth was restored, but with a surprisingly modest improvement in the unemployment situation. The FRG had been suffering from labor shortages most of the 1960's, so that the reemergence of unemployment as a serious problem at this time was unexpected.

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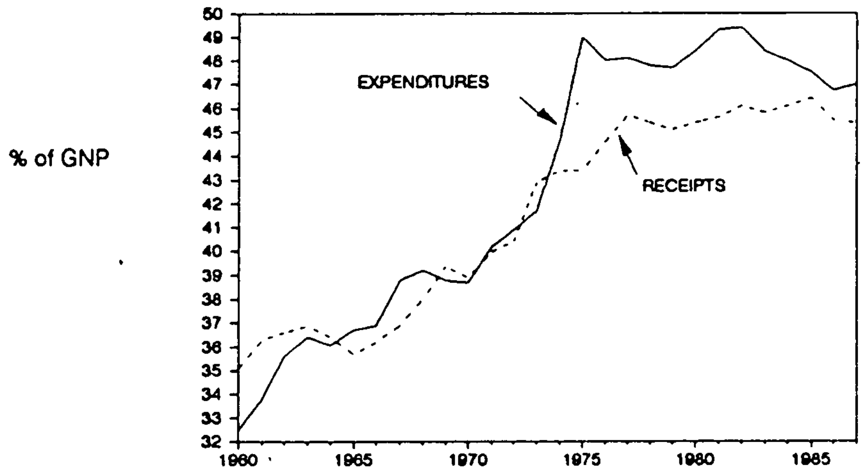
[3] Gerhard Fels and Hans-Peter Froehlich, "Germany and the World Economy," *Economic Policy*, April 1987.

[4] The social security system, which makes up over a third of the government budget, is not used for anticyclical policy. However, the system does have some automatic stabilizing effects, since revenues decline when the level of aggregate income falls, while payments rise.

FIGURE 11

GENERAL GOVERNMENT BUDGET



Before unemployment could be brought down substantially the second oil price shock rocked the world economy in 1979, causing unemployment to rise and depressing investment. Since that time unemployment has remained high. Total employment declined by 3 percent from 1970 to 1986, as employment in agriculture and industry fell 40 percent and 19 percent, respectively, while service sector employment increased only 22 percent. Unemployment rose from less than 1 percent of the labor force in 1970 to over 8 percent in 1986.

Although the government responded with fiscal and monetary stimulus to the recession that followed the second oil price shock, the effects were not sufficient to insulate the country from adverse developments in the world economy. During 1981 and 1982 there was no growth but substantial price inflation, and debt rose to high levels by postwar standards. (The ratio of government debt to GNP remained low relative to that in other OECD countries, however.) And in 1982 the governing SPD/FDP coalition was replaced by a CDU/CSU-FDP coalition, which shifted the policy focus from cyclical stabilization to reduction of fiscal deficits. Post-1982 policies are outlined in more detail later in this study.

The Primacy of Export-Led Growth

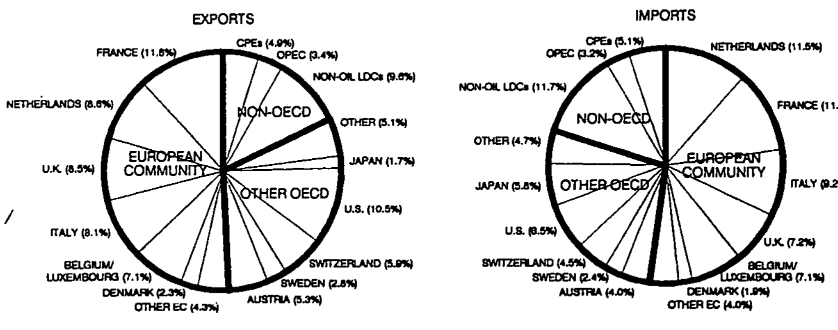
The emergence of the Federal Republic as a major economic power following the Second World War is often referred to as "the economic miracle." In 1945 Germany lay in ruins, the country's transportation system and a large part of its industrial base had been destroyed, and the population had suffered great losses—especially among persons of working age. The country was partitioned among the four major occupying powers, and in 1949 the British, French, and American zones became the Federal Republic of Germany. The German Democratic Republic (GDR) was established in the Soviet zone shortly thereafter.

The FRG's rapid economic growth during the 1950's was due in large part to a deliberate specialization in the production and export of capital goods. Foreign demand for these products was strong, as postwar reconstruction in Europe precipitated a surge in investment. By 1952 over half the country's exports were in the capital goods sector—and that level has persisted to the present day. Rising standards of living in the world have led to a gradual shift in the composition of these capital goods, from primarily producer durables to an increasing share of consumer durables.

The creation of the European Economic Community (now the European Community) in 1957 provided an especially favorable environment for the FRG's export-led expansion. Over the next four years the FRG's sales to the neighboring countries in the Community trebled, and today half the country's exports go to the EC. In the past few years the importance of the United States as an export market has grown appreciably. After hovering around 6 percent for many years, the share of the FRG's exports going to the United States rose sharply from that level in 1980 to 10.5 percent in 1986 (see Figure 12).

FIGURE 12

DIRECTION OF FRG TRADE IN 1986



Notwithstanding the Iron Curtain, exporters in the FRG early recognized the potential demand for their products in the centrally planned economies, particularly in Eastern Europe, and built markets there, in many cases facilitating the export of investment goods with long-term development loans. The FRG also found growing markets in the Third World.

The ratio of exports to GNP grew from less than 9 percent in 1951 to 18 percent in 1960, reflecting a 16.7 percent annual average growth of real exports, as compared to a real GNP growth rate of 8 percent. During the 1960's an annual average export growth rate of 7.6 percent propelled GNP growth of 4.5 percent per year. Even when the GNP growth dropped to only a little over 2 percent per year in the 1970's and 1980's, exports continued to average yearly

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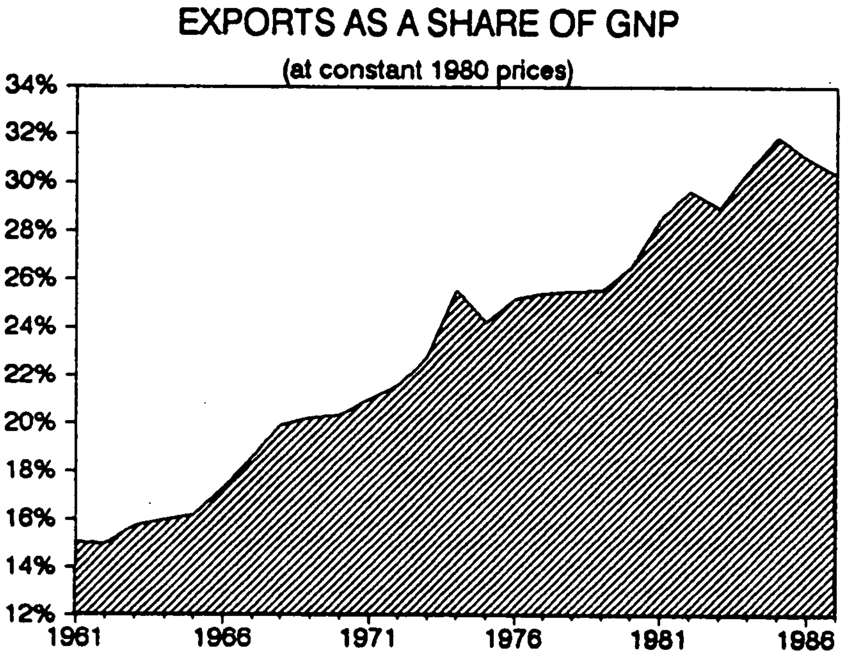
increases of 5 percent. The FRG's merchandise exports now account for roughly 30 percent of the country's output (see Figure 13), while in the United States the share is only 7.5 percent.

FIGURE 13



The FRG's balance of trade in manufactures has consistently been in surplus. These surpluses have more than offset the country's deficits in trade for other goods and large net transfer payments. The FRG depends on imports for almost all its oil and gas and for a substantial amount of its other basic commodities. It traditionally runs a large deficit on tourism accounts, and the outflow of foreign workers' earnings and payments to the European Community account for a large part of net transfers abroad (see Table 1).

TABLE 1.—FEDERAL REPUBLIC OF GERMANY—TRADE AND BALANCE OF PAYMENTS

[DM Billion]

	1980	1981	1982	1983	1984	1985	1986
Exports (fob) to:							
OECD	267.7	293.4	321.6	330.7	383.1	429.3	432.1
European Communities	172.0	186.0	205.9	207.8	232.8	254.9	267.4
United States	21.5	26.0	28.1	32.8	46.8	55.5	55.2
Non-oil developing countries	40.4	49.1	47.6	47.4	53.8	54.8	50.5
OPEC	22.8	34.9	38.0	31.6	27.9	25.2	17.9
Centrally planned economies	19.4	19.5	20.5	22.6	23.3	27.9	25.9
Imports (cif) from:							
OECD	248.2	271.9	280.0	298.0	330.2	357.0	331.3
European Communities	160.2	174.8	181.1	191.4	208.0	225.6	216.3
United States	25.7	28.4	28.2	27.7	31.1	32.3	26.8
Non-oil developing countries	38.3	40.6	42.3	42.8	50.4	53.4	48.3
OPEC	37.4	37.4	32.8	27.3	27.3	27.1	13.4
Centrally planned economies	17.5	19.3	21.4	22.2	26.4	26.3	21.2
Total commodity exports (fob)	350.3	396.9	427.7	432.3	488.2	537.2	526.4
Total commodity imports (fob)	331.4	357.3	365.2	378.5	421.4	451.1	402.9
Trade balance	18.9	39.6	62.5	53.8	66.8	86.1	123.5
Export of manufactures	259.1	290.6	318.6	317.0	356.3	400.6	402.4
Import of manufactures [1]	164.2	173.1	177.1	192.3	215.9	233.8	238.5
Net exports	94.9	117.4	141.5	124.7	140.4	166.8	163.9
Export of fuels	13.2	16.1	16.0	14.6	16.1	15.3	8.6
Import of fuels [1]	76.2	89.8	88.4	82.7	88.5	91.2	48.5
Net exports	−63.0	−73.7	−72.4	−68.1	−72.4	−75.9	−39.9
Export of other goods	78.0	90.3	93.1	100.7	115.8	121.3	115.4
Import of other goods [1]	101.0	106.3	111.0	115.2	129.8	138.9	127.3
Net exports	−22.9	−16.0	−17.9	−14.6	−14.0	−17.6	−11.9
Net services	−24.2	−27.6	−28.7	−21.1	−11.1	−10.3	−18.1
Net transfers	−22.6	−24.3	−25.5	−25.3	−30.1	−29.8	−27.6
Remittances of foreign workers	−7.5	−7.7	−7.7	−7.7	−8.4	−7.6	−7.0
Transfers to the EC (net)	−4.4	−6.5	−7.5	−6.1	−7.5	−8.2	−7.9
Current account balance	−28.5	−11.7	9.9	10.6	23.9	44.6	76.5
Net long-term capital transactions [2]	5.5	7.9	−14.9	−7.0	−19.8	−10.0	37.9
Net short-term capital transactions [2]	−3.7	−1.4	10.5	−8.8	−17.2	−40.9	−102.8

[1] Imports are recorded here on a c.i.f. basis.
[2] Net capital exports are denoted by a minus sign.

In foreign economic affairs the government has pursued trade liberalization, essential for any economy dependent on exports. The FRG has been a key supporter of the Western nations' efforts to reduce tariff barriers under the General Agreement on Tariffs and Trade (GATT). And, according to a recent World Bank study, the extent of the FRG's nontariff barriers is considerably less than the average for the major industrialized countries.[5]

The FRG's open trade policies have extended to the inflow and outflow of direct investment. Even though firms in the FRG lost most of their foreign assets during the war, by the early 1980's the stock of direct investment abroad was equivalent to $650–$700 per capita, while foreign direct investment in the FRG was equivalent to $500–$550 per capita. This is approaching the levels of outward and inward direct investment for the United States, which were equal to $968 and $585 per capita—and in sharp contrast to the figures for Japan, which were $514 and $34, respectively.[6]

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[5] J.J. Nogues, A. Olechowski, L.A. Winter, "The Extent of Non-tariff Barriers to Imports of Industrial Countries, *World Bank Working Papers*, No. 789, 1985.
[6] John Dunning and John Cantwell, *Directory of Statistics of International Investment and Production*, New York University Press, 1987.

Because the economy has been relatively open to foreign exporters and investors, FRG trade policies rarely have been the target of protest by other countries, despite the fact that FRG trade balances have almost always remained in surplus since 1952 and the economy has registered current account deficits in only five years since 1960.

Throughout the postwar period, export competitiveness has been a central objective of FRG economic policy. Until the abandonment of fixed exchange rates in 1972, a deliberate policy of domestic deflation held price increases down, keeping the deutsche mark undervalued and thus stimulating exports. Since 1972, under floating exchange rates, the government has encouraged capital flows to achieve the same result. The Bundesbank has fostered private capital outflows by keeping domestic interest rates low relative to rates in other industrialized countries. In addition, the Bundesbank supplemented private capital outflows, when necessary, by expanding its foreign currency reserves. During the 1970's the increase in official foreign exchange reserves equaled almost a third of the $125 billion in accumulated trade surpluses. In the 1980's, outflows of private capital, attracted by higher interest rates in the United States and the Euro-DM market, covered roughly half of the trade surpluses.[7]

The importance of export competitiveness remains at the center of the FRG's economic policy today, which explains why there is such resistance to the appreciation of the deutsche mark relative to the U.S. dollar, even as the FRG is running recordbreaking trade surpluses with the United States.

The Challenge of International Interdependence

Although economic summitry began on an informal basis in 1974 with the meeting of the U.S., FRG, French, and British finance ministers, the first formal annual summit of the heads of state of the world's major industrialized nations took place in 1975. The meetings were prompted in large part by the need to address the profound changes in the international economy brought about by the abandonment earlier in the decade of the Bretton Woods system of fixed exchange rates.

The first real commitment to the summit process, however, came at the July 1978 meeting held in Bonn, with the agreement by the summit participants to concrete measures to reduce international payments imbalances and stimualte economic growth. Each made specific commitments which they later fulfilled—the FRG and Japan moving to stimulate their domestic economies and the United States to reduce energy imports.

In the context of the commitments made during the Bonn summit, the FRG put into place an expansionary program that in other circumstances might not have been adopted. The Bundestag approved a multiyear package of expansionary measures, including a package of direct household tax cuts (DM 11 billion) and increased public spending (DM 4.5 billion). (A subsequent increase in

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[7] Until recently there have been some barriers placed on capital inflows into Germany, such as the 25 percent tax on nonresident income on bonds which was introduced in 1965. This tax was removed in 1984.

value-added tax rates gradually offset—by DM 6.5 billion—the lower revenues resulting from the initial tax cuts.) Further fiscal stimulus was provided at the beginning of 1980 with DM 6.75 billion of tax reductions and spending increases.

Economic performance in 1979 turned more vigorous than projected, with a 5.7 percent increase in domestic demand—led by higher business fixed investment—pulling GNP up by 4.4 percent. The employment situation improved, as the number of unemployed dropped by 117,000 persons. Also, as expected, the rapid growth in the FRG's imports helped to boost growth in other countries, particularly in Europe. This reduced the FRG's trade surplus by DM 20 billion and resulted in the country's first current account deficit since 1965. According to an assessment by the OECD, the FRG's simulation package had by 1980 ". . . made a major contribution to the expansion of demand in the OECD area and in Europe in particular." [8] In this respect the "locomotive" strategy had worked.

Coincidentally, however, the second round of OPEC oil price increases that began in 1979 soon caused DM prices to rise, hitting the economy with full force in the spring of 1980. Largely as a result of sharply higher oil import costs, the trade surplus declined DM 13 billion in 1980, pushing the current account deficit in that year to 1.3 percent of GNP. In addition, in late 1979 the U.S. Federal Reserve shifted unexpectedly to a restrictive monetary policy. In an effort to keep the deutsche mark from depreciating too rapidly the Bundesbank tightened its monetary policy, which caused interest rates to rise swiftly in the FRG.

GNP growth, which had been 4.0 percent in 1979, fell to 1.5 percent in 1980, 0.0 percent in 1981, and −1.0 percent in 1982. Final domestic demand in 1979-82 declined 5 percent, and unemployment rose from 3 percent to 7 percent. The net public debt nearly doubled, rising from 11.5 percent of GNP in 1979 to 19.8 percent of GNP in 1982 (see Figure 14).[9] With inflation running at a 6 percent annual rate by 1982, "stagflation" became a major issue in the FRG and led to a growing skepticism about international efforts to coordinate economic policies, especially those involving the FRG as a growth "locomotive."[10]

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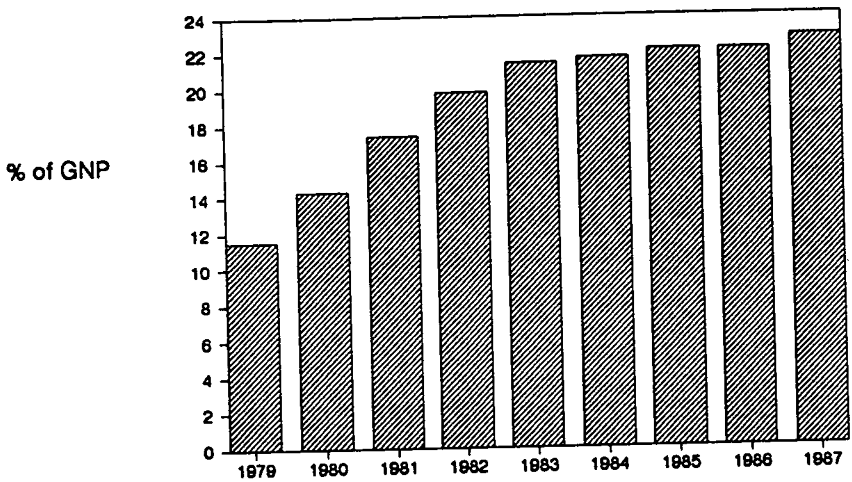
[8] OECD, *Economic Survey, Germany,* 1980, p. 33.

[9] Jean-Claude Chouraqui, Brian Jones and Robert Bruce Montador, "Public Debt in a Medium-Term Perspective," *OECD Economic Studies,* No. 7, Autumn 1986, pp. 103-153.

[10] Robert D. Putnam and Nicholas Bayne, *Hanging Together: The Seven-Power Summits,* Harvard University Press, 1984, pp. 94-99.

FIGURE 14

NET PUBLIC DEBT



CURRENT ECONOMIC POLICIES

In 1982 a new government came to power in the Federal Republic promising to bring about a "Wende"—a turnaround in economic policy. The new strategy of the governing CDU/CSU and FDP coalition was medium-term oriented, placing the emphasis of fiscal policy on budget consolidation, with reductions in the public sector deficit to be achieved primarily on the expenditure side. In conjunction with this, the Bundesbank has focused on stabilizing expectations and confidence in the currency, and in holding down inflation.

Progress has been made in moving toward some of the government's objectives. The general public deficit has been reduced from 3.3 percent of GNP in 1982 to 1.2 percent of GNP in 1986. Price inflation was brought down as well. The annual increase in industrial producer prices dropped from 5.8 percent in 1982 to minus 3 percent in 1986, and the consumer price increase went from 5 percent to zero. And in the four years 1983-86, there was positive real growth every year, with GNP increasing at an average annual rate of 2.4 percent.

However, the government's policies have not been as successful in meeting the other goals set out in the Law to Promote Stability and Growth. The rate of unemployment rose from 4.4 percent of the labor force in 1981 to 8 percent in 1983, and has remained between 8 percent and 9 percent since then. Imports have increased slowly, at less than half the rate of exports, leading to large and persistent trade surpluses. According to the OECD, the "rising current account surplus is at variance with the goal of external equilibrium and there has been a failure to meet the high employment objective."[1]

The rapidly rising current account surplus was due to a combination of very weak growth in domestic demand, the rapid rise in foreign demand for German exports brought about by the strength of the U.S. dollar relative to the deutsche mark, and, more recently, by savings from the fall in oil and other import prices. Almost all of the FRG's growth in the period 1980 to 1986 depended on external demand, a large part of which was due to rising trade surpluses with the United States. During this period, domestic demand rose less than 5 percent in total, while the current account balance went from −1.3 percent of GNP in 1980 to 4.1 percent of GNP in 1986. The current account surplus with the United States alone equaled 2 percent of GNP in 1986.

This growth path appears to be unsustainable. External sources of demand for the FRG's output are now shrinking. The United States has been accumulating deficits with most of its major trade

[1] OECD, *Economic Survey, Germany,* 1986, p. 8.

partners since 1981, and its level of foreign indebtedness has reached the point where both government actions and market forces are acting to reverse the trade trends of the past five years.[2]

The volume of goods and services exports fell 0.1 percent in 1986 and is estimated to have shown no growth in 1987. Although record nominal trade and current account surpluses continued to be recorded in 1986 and 1987, this was the result of a sharp drop in the cost of imported oil and the effect of an appreciating DM. Fuel import prices fell by 40 percent from the first quarter of 1986 to the first quarter of 1987, but have remained relatively stable since. Unless other sources of demand replace the stimulus of increasing net exports, growth in the FRG will be seriously curtailed. Such a slowdown in the FRG's growth would not only aggravate problems at home but would add to the deflationary pressure on the world economy at a critical time.

Even with unemployment at levels not experienced since the early postwar period, the government has generally taken the position that unemployment should be addressed by focusing on economic policies that induce additional private investment by enhancing business profitability. Recent legislation has relaxed rules relating to fixed-term contracts, making it easier to hire temporary workers; improved the legal framework for employees working part time or job sharing; and reduced mandatory severance pay in cases of large-scale layoffs.

Despite these policies the employment situation has worsened. In 1986, 25.8 million people were employed, only a 0.3 percent increase on the figure for 1982. Over the same four-year period, the number of unemployed increased by 22 percent, reaching a total of 2.2 million in 1986. Of that number, only 30 percent are older than 45. The remaining 1.5 million younger workers will be needed within the next decade as the total number of persons of working age begins to decline. Yet their skills and motivation are deteriorating through long-term unemployment, a loss that will compound and prolong the lost output and social welfare costs associated with the current high level of unemployment. Nonetheless the government has defended its labor policies by arguing that the unemployment problem will take care of itself over time, given the country's demographic structure. A 1 percent annual decline in the labor force is projected over the next decade so that, assuming the number of jobs currently available is maintained, the unemployment rate would decline automatically.

[2] Joint Economic Committee, *The Economy at Midyear: A Legacy of Debt,* U.S. Government Printing Office, 1987.

THE NEED FOR STRONGER GROWTH

Until the middle of 1986 it appeared that the Federal Republic of Germany was set to enter a period of ". . . spontaneous market-generated recovery of investment and private consumption that would fuel a durable expansion of output without jeopardizing price stability." [1] Since mid-1986, however, economic performance has not met expectations. Real GNP growth in 1987 is estimated at only 1.7 percent, and little improvement is expected for 1988 in the absence of changes in government policies. In the wake of the October crash in financial markets, the official government forecast for real GNP growth in 1988 is 1.5 percent to 2.0 percent, and the forecast of the Council of Economic Experts is 1.5 percent.[2] The Council also foresees an increase of 70,000 persons on the unemployment rolls. Similarly, the most recent OECD projection shows output growing at an annual rate of less than 1.5 percent over the next three years under currently planned fiscal policies.[3]

The economy appears to be caught in a vicious cycle: lackluster domestic growth prospects, leading to low rates of investment and rising unemployment. Rising exports to the United States can no longer be counted on to serve as the growth engine.

The Federal Republic's budget consolidation effort during 1982–85 was made easier by an overvalued U.S. dollar, which stimulated a rapid growth of net exports. In turn this compensated for the dampening of domestic demand caused by the consolidation effort. The substantial appreciation of the deutsche mark relative to the dollar since 1985 is now working in the opposite direction. This creates a situation in which government policy is now needed to stimulate private demand.

Since the U.S. market accounts for only 10.5 percent of the FRG's total exports, with an additional 10 percent going to other dollar-based markets, the significance of the changing DM-dollar relationship can easily be underestimated. What these figures do not reveal is how important the sharp rise in exports to the United States was to the FRG's growth in the 1980's. On an aggregate level, in the period 1982–86, the increase in FRG merchandise exports to the United States accounted for 27 percent of the total increase in exports. For many companies, particularly those producing luxury goods or high-tech products, U.S. markets account for a much larger than average share of their sales and profits. Roughly a quarter of FRG exports to the U.S. market consists of luxury

[1] OECD, *Economic Survey, Germany,* 1986, p. 7. See also Joint Economic Committee, *Germany's Coming Economic Revival,* U.S. Government Printing Office, 1986.

[2] The Council of Economic Experts was set up in the mid-1960's to provide analysis, forecasts, and policy advice to the FRG Government. The Council is a nongovernmental body consisting of five academic economists selected by the chancellor.

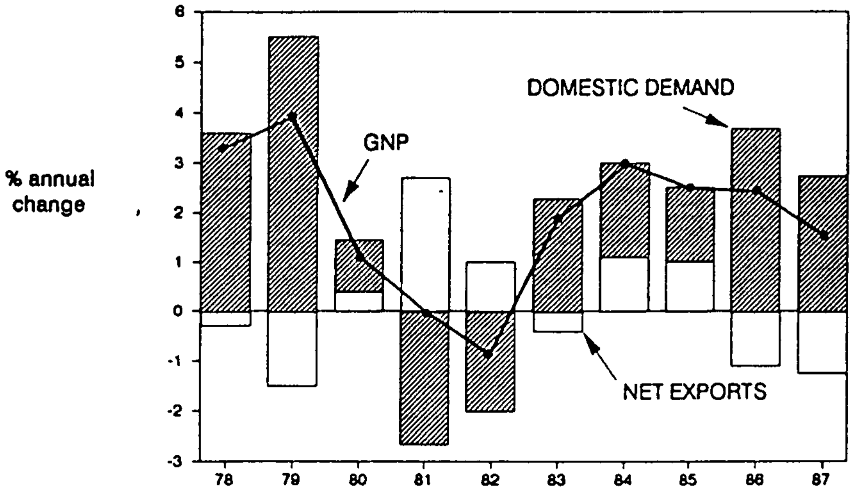
[3] *OECD Economic Outlook,* No. 42, December 1987, p. 92.

class automobiles. Thus the direct impact of a depreciating dollar on the FRG's exports to the United States could be significant.

Over 80 percent of the FRG's real GNP growth in the period 1981–85 was due to a growing external surplus (see Figure 15). Of the total DM 73 billion increase in the FRG's current account balance during this period, increases in the balance with the United States accounted for DM 40 billion, or over half the total increase in the first half of the eighties.[4]

FIGURE 15

COMPONENTS OF GNP GROWTH



Since 1985 the DM's appreciation relative to the dollar has equaled its earlier decline. The result for the FRG has been declining net real exports. This has placed a drag on the economy's growth, although the effect was partly hidden in 1986–87 because declining oil prices and improving terms of trade gave a boost to private consumption. But this relief is likely to prove temporary, and when it subsides, the underlying weakness of domestic demand will come to the surface.

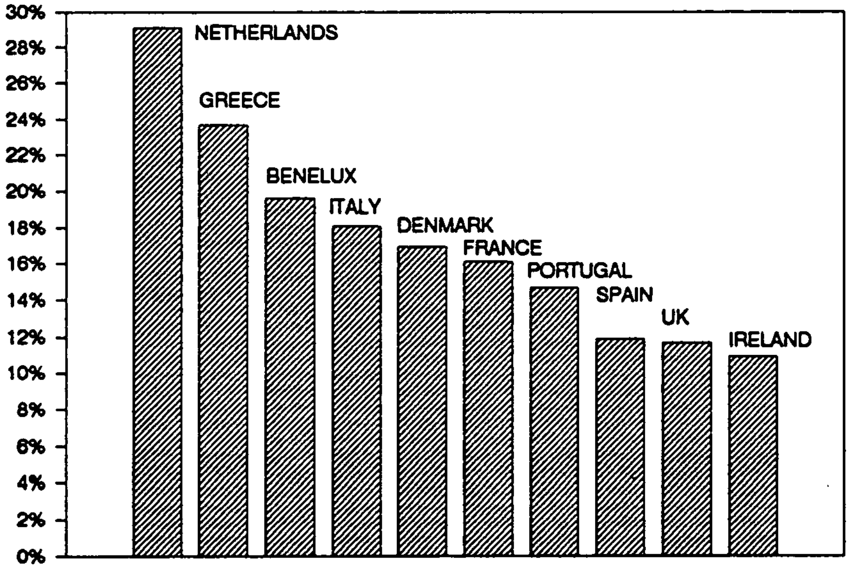
An economic growth slowdown in the FRG would have the effect of holding down growth throughout Europe, with the impact felt through both the trade and financial linkages that closely bind together the West European economies. The FRG is a major market for the other countries, in 1986 absorbing 12 percent of the United Kingdom's merchandise exports, 16 percent of France's, 18 percent of Italy's, and 29 percent of the Netherlands' (see Figure 16).

[4] According to U.S. Department of Commerce figures the current account deficit with the FRG went from $3.2 billion (DM 5.8 billion) in 1980 to $16 billion (DM 47 billion) in 1985, while according to OECD reports the FRG total current account balance went from a DM 28.5 billion deficit to a DM 44.6 billion surplus.

Slower growth in the FRG would mean less trade for the rest of Europe, and therefore slower growth. Other European countries would find it difficult to compensate for the loss of demand through more stimulative fiscal or monetary policies of their own, since too great a divergence between their economic policies and those of the FRG would simply lead to an outflow of capital, which would counteract much of the impact of any stimulus. This would be particularly true for those countries who are members of the European Monetary System.

FIGURE 16

SHARE OF EXPORTS TO THE FRG



The impact of reduced growth and trade in the FRG and Europe would spill over into the rest of the world's economy. The United States would find itself having to rely increasingly on dollar depreciation to reduce its trade deficit. If as a consequence U.S. interest rates were to rise, heavily indebted developing countries would be left with an additional debt service burden, since interest payments on much of their debt are based on U.S. rates. These ripple effects in the world economy would generate yet another cycle of less trade, lower growth, and wasted resources.

The Official Position

The FRG's response to the slowdown has been to point to tax cut and money supply policies put in place in 1986 at a time of relatively high growth, and to argue that these policies—with only small marginal adjustments—may serve over time to revive growth:

Fiscal policy.—A phased tax-reduction program went into effect in 1986, when personal income taxes were reduced by some DM 11 billion. The second stage, cutting income and business taxes by approximately DM 14 billion, is scheduled for 1988, and an additional cut of DM 25 billion is proposed but not yet formally approved for 1990. (The 1988 tax cut was originally planned to amount to DM 8.75 billion, but was increased by DM 5.25 billion after discussions between the United States, Japan, the United Kingdom, France, and the FRG at the Louvre in February 1987.) The government has indicated a willingness to accept for the time being the additional revenue shortfalls caused by the slowdown in the economy.[5]

Monetary policy.—Since the beginning of 1986 the Bundesbank has allowed the money supply to expand more rapidly than nominal GNP and above its own targeted rates. The bank has indicated that it will continue this policy if the economy remains sluggish. In addition the bank has helped to bring down short-term interest rates by lowering its repurchase and discount rates. Nominal interest rates are currently at their lowest level in a decade (see Figure 17), although real short-term and long-term interest rates remain at a high level compared with rates over the past 20 years (see Figures 18 and 19).

[5] Government revenues have been adversely affected by the decline in Bundesbank profits which are transferred to the federal budget. Due to the depreciation of the U.S. dollar, the bank has had to write-down its dollar reserves.

FIGURE 17

NOMINAL INTEREST RATES

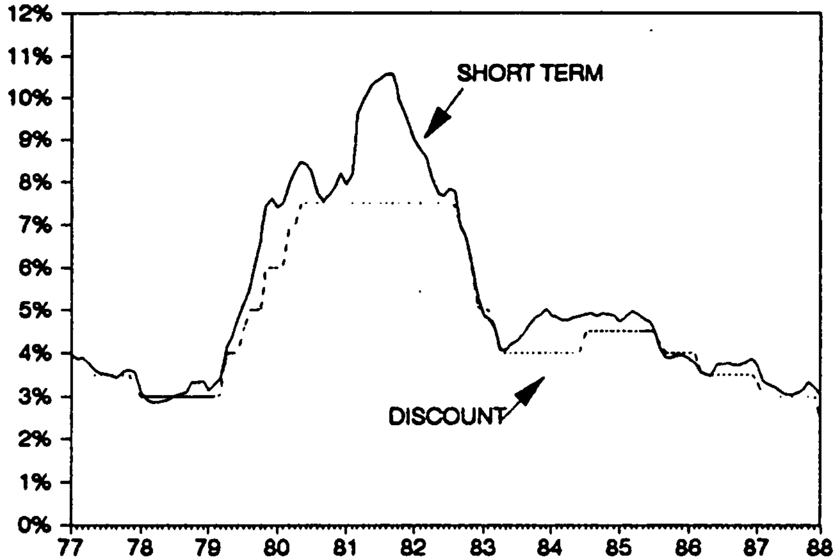


FIGURE 18

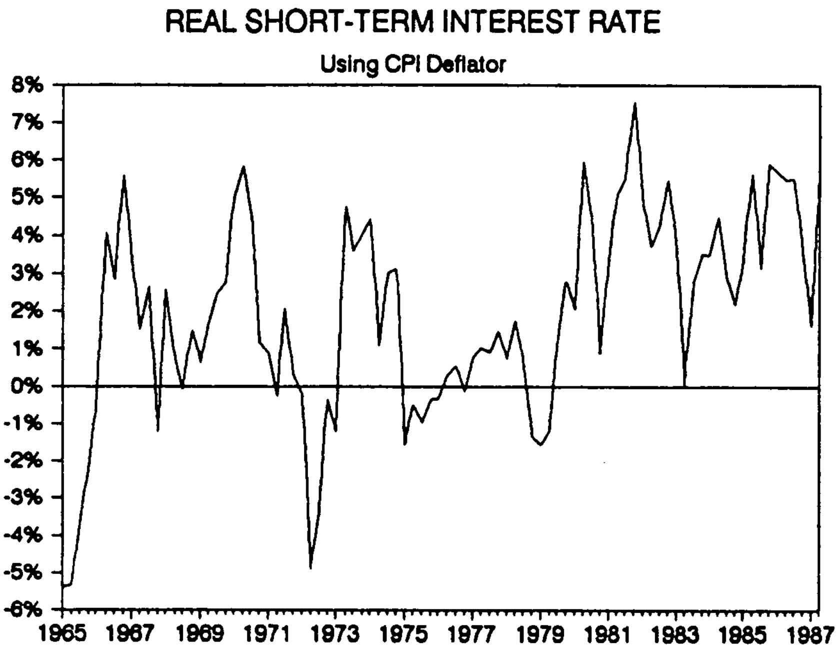
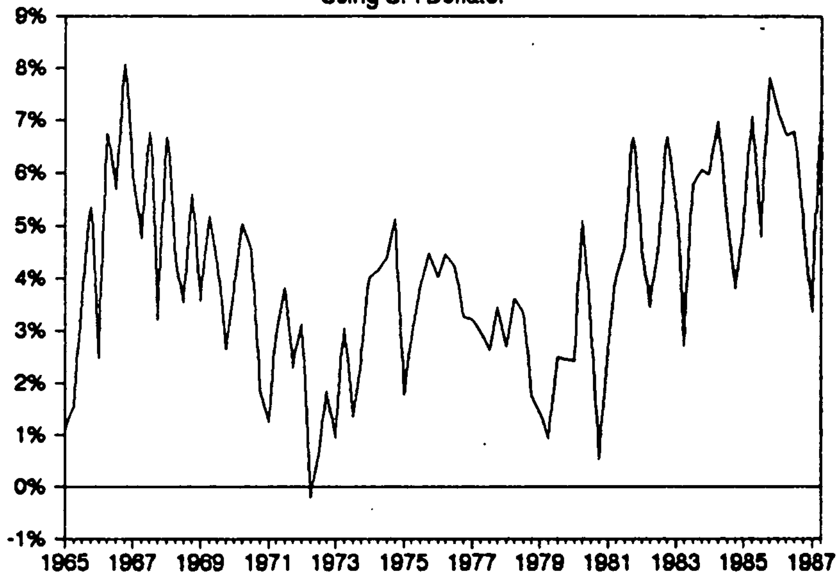

REAL SHORT-TERM INTEREST RATE
Using CPI Deflator
8%
7%
6%
5%
4%
3%
2%
1%
0%
-1%
-2%
-3%
-4%
-5%
-6%
1965
1967
1969
1971
1973
1975
1977
1979
1981
1983
1985
1987

FIGURE 19

REAL LONG-TERM INTEREST RATE

Using CPI Deflator

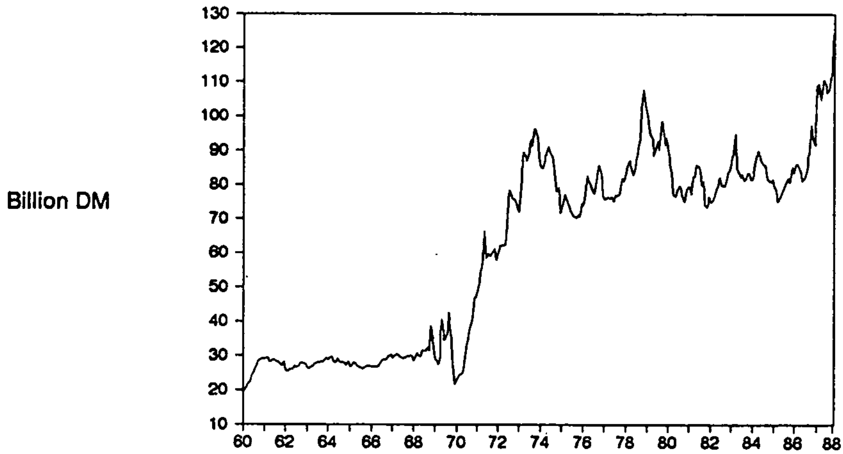


Kreditanstalt lending.—At the end of 1987 the government announced that the state-owned bank, Kreditanstalt für Wiederaufbau, would, over the next three years, make available an additional DM 21 billion for loans to municipalities and small businesses for investment purposes. The interest on these loans is to be subsidized from the federal budget at a cost of DM 200 million a year. In large part, the government is simply trying to prevent a reduction in local spending as a consequence of the drop in local tax revenues that has accompanied slower economic growth. Therefore, it is unlikely that this measure will stimulate growth beyond the modest rates expected before the recent slowdown.

At the same time, in order to help stabilize exchange rates, the Bundesbank, along with other major central banks, has been intervening in currency markets by buying dollars. Of the net $100 billion plus purchased by central banks in 1987, the FRG's share has been estimated at more than $10 billion (see Figure 20). In effect, the Bundesbank is extending a loan to the United States, since it acquires the dollars and then invests them in Treasury bills or other debt instruments issued by the U.S. Government. For the FRG there are some costs involved in this intervention. Since the purchases are not completely "sterilized" (i.e., counteracted by central bank operations on the domestic financial market), the increase in reserves has caused a rapid monetary expansion, which government officials see as posing an inflationary threat. In addition, the purchase of dollar denominated debt instruments exposes the Bundesbank to an exchange rate risk. The primary benefit to the FRG is that a stable or more gradually declining $/DM exchange rate eases the structural adjustment that the FRG economy is going through as it shifts from export-oriented production to production more suited to domestic demand.

FIGURE 20

TOTAL FOREIGN ASSETS OF CENTRAL BANK



The Call for Additional Measures

The measures undertaken so far are unlikely to get the FRG's economy back up to its potential growth rate. In fact, most of these measures have been incorporated in the forecasts mentioned above, which project only a weak fiscal stimulus in 1988 and, as a result, slow growth. There have been repeated calls, therefore, for additional measures to increase growth. These include acceleration of the tax cuts currently projected for 1990, an across-the-board income tax reduction up to a maximum of 10 percent, and job-creating public investment projects. Separate reports issued by the Commission of the European Communities and the OECD emphasize that growth prospects throughout Europe would be considerably improved by more rapid expansion in the Federal Republic.[6]

Monetary policy could also be used to provide further stimulus to the economy by bringing down interest rates. The Bundesbank has

[6] Commission of the European Communities, *European Economy,* No. 33, July 1987, p. 47, and Organization for Economic Cooperation and Development, *OECD Economic Outlook,* No. 42, December 1987, p. xi.

resisted further easing out of concern about the rapid growth of money supply in 1986 and 1987. Central bank money expanded by over 8 percent both years compared to target ranges with upper limits of 5.5 percent. However, experience in recent years in the FRG and elsewhere has been that changes in the money supply are unreliable as an economic indicator and a policy guide.

A reduction in interest rates would not only help stimulate growth in the FRG, it would also give the United States some latitude to reduce rates without facing renewed downward pressure on the exchange value of the dollar. The same would apply for the EMS countries. When the Bundesbank lowered its discount rate to 2.5 percent in December 1987, several other EMS countries took this as an opportunity to immediately lower their rates as well.

In addition to these macroeconomic measures, there are institutional and structural changes that could promote growth by raising efficiency, increasing employment, stimulating consumption, or opening up the economy to increased foreign competition. Among those which have been under discussion in the FRG are proposals to open up the telecommunications industry to allow outside vendors to compete for equipment sales and supply value-added services, and to revise the Shop Closure Law (Ladenschlussgesetz) which restricts the hours during which stores can operate and is thought to hold down consumer buying.

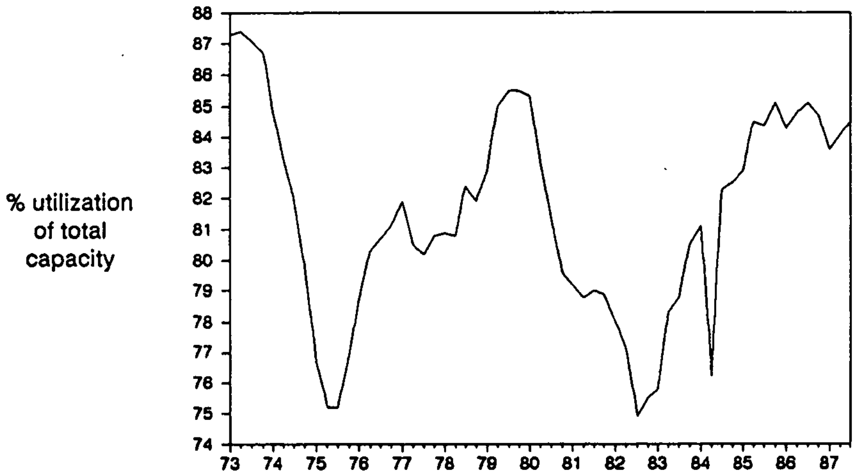
The Continuing Debate

Much of the debate in the FRG about the efficacy of additional fiscal stimulus centers around the question of whether the economy is demand constrained or supply constrained. The persistent high level of unemployment, the low level of investment, and the lack of any significant inflation are strong indications of inadequate demand. However, the government has focused on the supply side of the equation, predicating its policies on the assumption that the economy's growth is constrained by the supply of both capital and labor. It does appear that capacity utilization in manufacturing has risen to a relatively high level (see Figure 21). This may be explained by the fact that:

> . . . during the protracted period of adjustment to the two oil shocks and related international developments, investment activity was depressed relative to previous trends and biased against capital-widening. . . . As a result, the extension of employment capacity of the (only slowing growing) capital stock has not kept pace with the expansion of the potential labor supply.[7]

FIGURE 21

CAPACITY UTILIZATION IN MANUFACTURING



There appear to be ample opportunities for noninflationary growth, although this growth may need to be investment led or focused on those sectors of the economy relatively less constrained by current capital capacities. The opportunity for investment-led growth seems favorable, as capital returns and profitability have risen in recent years. The second opportunity is also likely to occur, since the appreciation of the deutsche mark is expected to redirect growth away from exports, and thus from manufacturing.[8] Over the period 1973–84 the capital stock in the service sector (excluding housing) increased by over 4 percent per year on average, compared to a growth rate of only 2.7 percent in the goods-producing sectors. The most rapid growth has been in transportation, business, and financial services. Growth in these sectors is less likely to be constrained by capital capacity than in manufacturing.

Skepticism comes also from labor force problems—related to the regional, skill, and age distribution of the unemployed. Some of these problems warrant attention, but many labor market studies indicate that a significant reduction in unemployment could be achieved through noninflationary growth. The IMF and the OECD have separately made calculations suggesting that unemployment in the FRG could be reduced to 6 percent or less without initiating accelerating inflation.[9]

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[8] Morgan Guaranty Trust Company of New York, "Germany's Growth Predicament," *World Financial Markets,* June/July 1986.

[9] Charles Adams, Paul R. Fenton, and Flemming Larsen, "Potential Output in Major Industrial Countries," *IMF Staff Studies,* August 1987, p. 17; *OECD Economic Outlook,* No. 40, December 1986, p. 30.

As noted above, labor policy since 1982 has focused on increasing labor-market flexibility. There have been some significant legal and institutional improvements. But in the absence of additional demand, it is questionable how much such improvement will accomplish. A 1987 Brookings Institution study of the European economies builds a strong case for coupling structural reform in labor markets with more expansive macroeconomic policies, concluding that ". . . structural improvements in labor markets are much more likely to occur when an economy is expanding than in the current environment of highly restrictive policy and slow growth." [10]

Still, policymakers continue to place concerns about the possibility of inflation above efforts to address continuing high unemployment. This concern about inflation persists at a time when import prices, sharply falling in the last several years with the decline in oil prices and the appreciation of the deutsche mark, have pushed producer prices down and held consumer prices constant since 1985 (see Figures 22 and 23).

[10] Robert Z. Lawrence and Charles L. Schultze, eds. *Barriers to European Growth: A Transatlantic View,* The Brookings Institution, 1987, p. 45.

FIGURE 22

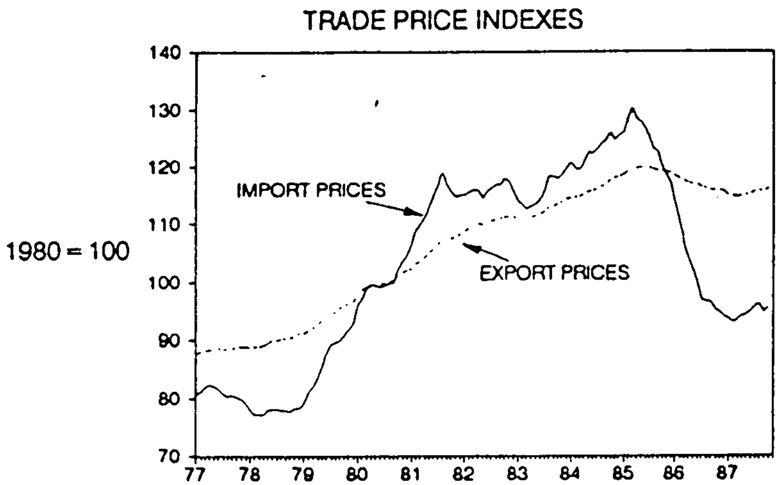
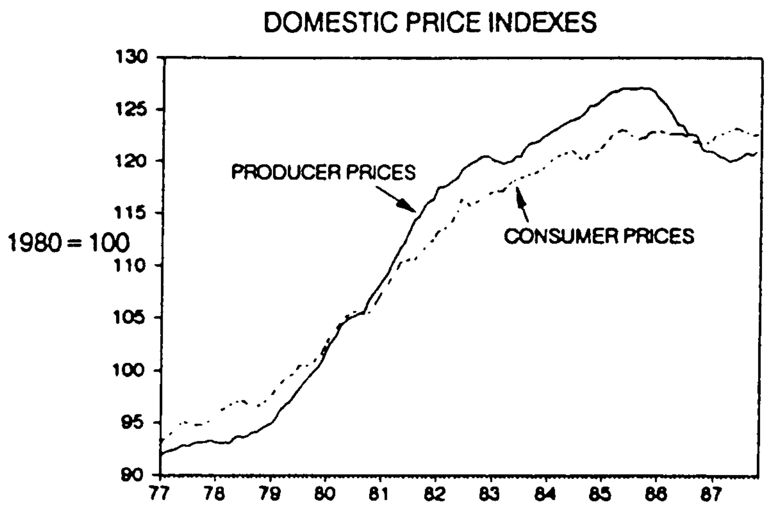


FIGURE 23



Another concern of the government is the long-term inflationary impact of a larger budget deficit. Projections by the FRG Council of Economic Experts show that with the currently planned tax cuts the overall public sector deficit could rise to DM 85 billion in 1990. These figures are highly provisional, and both their level and significance depend on the assumptions made about the economy's overall growth.

But it is likely that the government's deficit will rise relative to GNP for the next several years. The tax cuts were initiated with this understanding, although without the expectation of the economic slowdown now occurring. Any increase now would occur at a time when the ratio of the deficit to GNP is low. Four years of budgetary consolidation lowered the level of current deficits from 3.7 percent of GNP in 1981 to 1.1 percent in 1985. While it has risen slightly since then, it is still low by comparison with the levels of the past decade. In addition, the level of accumulated public debt is modest by international standards—in 1986 net public debt as a percent of GNP was 22 percent for the FRG, 29 percent for the United States, and 26 percent for Japan.[11] Given the government's attachment to fiscal prudence, a temporarily higher debt-to-GNP ratio should not unsettle policy credibility. Furthermore, the measures suggested are modest in scope and, given current high unemployment and low inflation, appear likely to foster stronger economic growth in the FRG.

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[11] Jean-Claude Chouraqui, Brian Jones and Robert Bruce Montador, "Public Debt in a Medium-Term Perspective," *OECD Economic Studies*, No. 7, Autumn 1986.

RESTORING INTERNATIONAL BALANCE: LONGER TERM MEASURES

A program of temporary stimulus by the Federal Republic of Germany would help ensure faster growth both in that country and throughout Europe, thereby helping to restore balance in the global economy. The policy adjustments outlined thus far, however, address the cyclical but not the structural aspects of the problem. The FRG's traditionally high level of private savings means that, even with substantially faster growth and expanded imports, the nation is likely to run persistent trade and current account surpluses over the long term.

If the surpluses are to be reduced, or redirected in such a way as to make them sustainable, additional measures will be necessary. There are two in particular that deserve careful consideration: assumption by the FRG of defense responsibilities within the Western mutual security system more nearly commensurate with its economic resources; and a greater flow of FRG savings to other parts of the world, especially the heavily indebted middle-income countries. Each is discussed briefly below.

THE FRG CONTRIBUTION TO WESTERN SECURITY

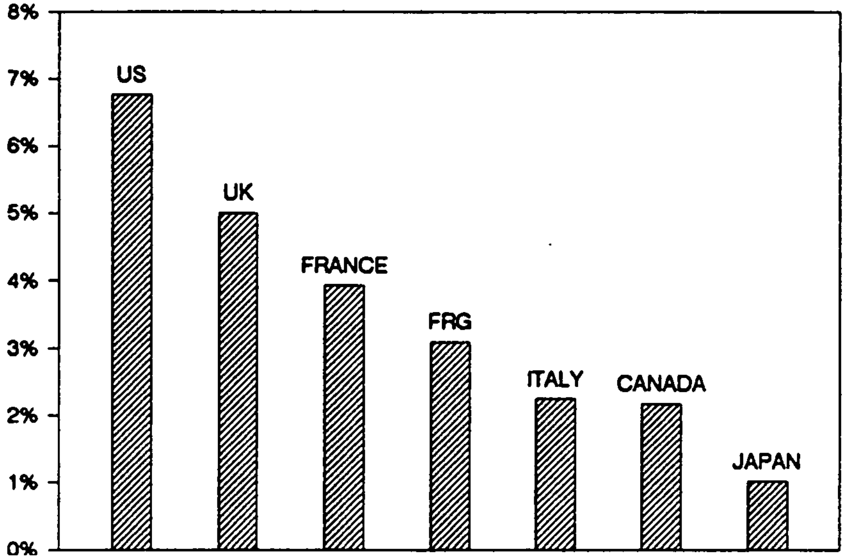
The Western mutual security system, in which NATO plays a central role, was established in the years following World War II. Within the system the United States assumed responsibilities that were consistent with the relative strength of the U.S. economy in the postwar period. Since that time the economies of the allied countries have expanded and strengthened dramatically. Nonetheless the United States continues today to carry out security responsibilities that were set at a time of undisputed U.S. hegemony in the world economy.

By virtually every criterion, the financial contribution of the FRG to the mutual security system linking 16 countries in Western Europe, North America, and Japan is relatively modest. In 1986 FRG defense spending as a share of gross domestic product (GDP) was 3.1 percent, compared to 6.7 percent for the United States and 3.3 percent for the non-U.S. NATO weighted average.[1] For the largest NATO countries, France and the United Kingdom, the shares were 3.9 percent and 5.0 percent, respectively. The only NATO members spending less as a percentage of GDP than the FRG were Belgium, Canada, Denmark, Italy, Luxembourg, and Spain (see Figure 24).[2] Japan, whose defense expenditures are limited by constitutional and formal political commitments, spent the equivalent of 1 percent of its GDP.

[1] GDP differs from GNP by excluding the net flow of income on foreign investments.
[2] Department of Defense, *Report on Allied Contributions to the Common Defense,* 1988.

FIGURE 24

RATIO OF DEFENSE SPENDING TO GDP, 1986



Within the alliance, including NATO and Japan, the FRG in 1986 accounted for 6.4 percent of total defense spending while representing 8.9 percent of the combined GDP of NATO members and Japan. For the United States the relationship was reversed, with the United States contributing 65.2 percent of total defense spending and representing 41.3 percent of combined GDP.

The disparity in defense contributions is also evident in a comparison of expenditures on a per capita basis. Using the Department of Defense (DOD) estimate that U.S. defense spending for NATO purposes accounted for 58 percent of total U.S. defense spending, per capita spending for NATO was $675. Even assuming that all FRG defense expenditures are NATO directed, the FRG per capita contribution is only two-thirds that of the United States.

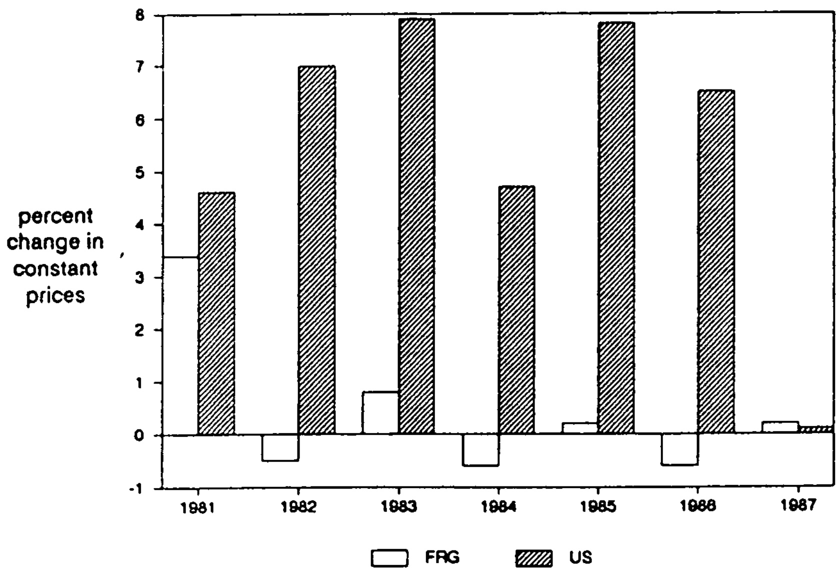
These financial measures do not fully reflect the importance of the West German contribution to the Western defense system. The West Germans rely on conscription, which produces relatively large trained reserve forces and which holds down manpower costs by paying below-market wages, while the United States instead relies on all-volunteer forces. The FRG also makes land and facilities available without cost to U.S. forces stationed in the country, and contributes significantly to foreign troop maintenance in Berlin. Furthermore, the stationing of foreign troops on FRG territory involves social and psychological costs, and military exercises inevitably create the risk of accidental death and property damage. The Congressional Budget Office has estimated that the costs of conscription, the value of land made available to foreign troops, and West German contributions to maintenance of forces in Berlin raise FRG expenditures for defense by an additional 0.6 percent of GDP.[3]

In addition, the FRG expenditure in foreign economic assistance as a percentage of GDP is considerably higher than the United States, 0.4 percent as compared to 0.2 percent. Nonetheless, the expenditure is small, $3.8 billion in 1986, while GDP in that year was $895 billion.

Taking all the above factors into account, however, the total FRG commitment for defense and economic assistance constitutes 4.1 percent of GDP, as compared to 7 percent for the United States. What is more, the disproportion in relative contributions has increased over this decade. Expressed in constant prices, U.S. GDP rose by 21 percent in 1980–87 while U.S. defense spending went up by 45 percent. GDP in the Federal Republic rose by 11 percent during this period, but defense spending increased by only 2.9 percent (see Figure 25). As a result the FRG's defense spending as a share of GDP actually declined.

FIGURE 25

GROWTH IN DEFENSE SPENDING



[3] Statement of Robert F. Hale, Assistant Director, National Security Division, Congressional Budget Office, before the Committee on the Budget, U.S. Senate, Mar. 1, 1988.

The impact of their respective levels of defense spending has affected the basic economic balances of each country. The declining share of defense spending facilitated the FRG's budget consolidation effort. In the United States, on the other hand, the rising share of GDP going into defense was an important factor in the increase in the public sector deficit, which rose from 1 percent of GDP in 1981 to 3.8 percent in 1983, declining only slightly to 3.4 percent in 1987.

Over the last 40 years, a major shift has taken place in the economic and political capabilities of NATO member nations, and the traditional economic contribution from the United States no longer appears appropriate. A more realistic sharing of responsibilities among the partners would facilitate the shift of some defense expenditures currently carried by the United States to other NATO nations. While the overall level of NATO spending would be determined, as it is now, by the perceived defense needs of the alliance as a whole, its allocation would bear a closer relationship to the member countries' relative economic strength.

Addressing the Third World Debt Crisis

With excess savings to invest elsewhere in the world, there has been a natural tendency for German investors to direct them toward the more developed economies of Eastern and Western Europe and North America. The more pressing international need at this time, however, is for a new flow of savings to the heavily indebted middle-income countries, whose efforts to deal with their excessive debt burdens have led to deep recessions. These in turn have depressed world demand and created strains in the world trading system, contributing to the international economic imbalances that have developed over the course of this decade.

The debt crisis came to public attention in August 1982, when Mexico announced that it would be unable to service its debts to foreign banks and governments. In the past six years, the magnitude of the problem has become clear, as more than 40 countries have been unable to meet their scheduled debt service payments. Many of these countries have undertaken substantial internal adjustments in an effort to meet their foreign obligations, but private lending to them has been cut back sharply.

The result, as most of the adjustments have been overwhelmed by the speed and magnitude of private capital withdrawal, has been a negative net resource transfer and an intensification of the crisis. Whereas in 1981 total private lending to developing countries was $87 billion and constituted 56 percent of their external financing, by 1986 private lending had declined to $10 billion and made up only 13 percent of the total.[4]

This sharp contraction has meant that resources which otherwise would have been directed to domestic growth have been diverted instead to debt service payments. Debtor countries have reduced imports and expanded exports in order to produce the trade surpluses necessary to meet their debt service obligations. Gross capital formation and the rate of economic growth have fallen signifi-

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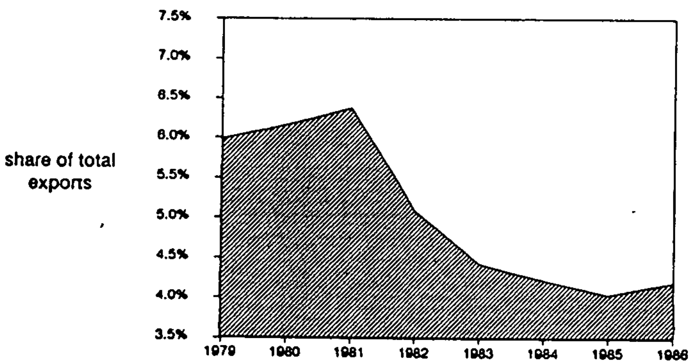
[4] IMF, *Annual Report*, 1987, Table 9, p. 29.

cantly. Many debtor countries are now caught in a vicious cycle, requiring significant infusions of new capital in order to resume growth, but unable to attract new capital until growth has resumed.

The debt crisis has had severe adverse consequences for the industrialized nations as well. The faltering efforts by many debtor countries to service their loans have weakened the financial sector in the creditor countries. Debtors' austerity programs, diverting resources from investment and consumption to debt service, shrank what had been thriving export markets for the industrialized countries. The FRG has been severely affected, with FRG exports to the 15 most heavily indebted countries falling by more than one-third in the 1981–87 period (see Figure 26). (The United States was probably hardest hit, since the United States has traditionally had close ties to the major debtor countries; between 1981 and 1986 a $20 billion trade surplus in manufactured goods with the major debtor nations virtually disappeared.)

FIGURE 26

FRG EXPORTS TO MAJOR DEBTOR COUNTRIES *



* Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

It is clearly important that the Federal Republic assure access to its markets for debtor nations' exports. As one German economist has noted, "Without an opening of Japanese and German markets, the 'real transfer' problem of the debtor nations cannot be solved. They cannot service their debt if they cannot sell their products in industrial countries' markets." [5]

But the debt crisis is now into its seventh year, and there has been only modest response to the piecemeal and unilateral efforts thus far to address it. The 1985 Baker Plan represented a constructive departure from the narrow focus on debtor countries' domestic adjustment programs, combining a case-by-case approach to the

[5] Norbert Walter, *West Germany's Economy,* p. 30.

debt problem with a proposed three-year, $29 billion program of new lending by banks and international financial institutions to the 15 most heavily indebted nations. The results have fallen well short of the expectations of the Plan's proponents, however, and the experience since 1985 suggests the need for a more concerted, comprehensive approach to the problem.

An intermediate debt facility could provide the multilateral framework for reducing and restructuring the debt of heavily indebted developing countries. Tying debt reduction to a debtor nation's policy reform, the facility would purchase debt at a discount from the commercial banks and pass the discount along to the borrower in the form of restructured repayment obligations. In so doing, it would help to regularize a process already underway, since developing nations' loans are already being sold at discount prices on world secondary markets, and ensure that the discount is indeed passed through to the debtor nation urgently in need of it.

An international mechanism of this kind could provide an effective channel for directing the world's large current account surpluses toward world economic growth objectives, much as the Marshall Plan did in the wake of the devastation of World War II and as the IMF's special "oil facility" did in response to the oil price shocks of the 1970's. Redirection of some portion of the West German surpluses means an assumption by the FRG of responsibility in the world economy consistent with the importance of the FRG in the world economy. It would also constitute a major contribution to the health and growth of the world economy.

CONCLUSION

Current global trade imbalances cannot be sustained over the long term. If careful and coordinated steps are not taken to address them, the inevitable adjustment is likely to be sharp and painful. Ideally, adjustment measures should be taken on all sides, with the surplus nations moving to reduce their surpluses by stimulating world demand and the deficit nations acting to reduce their deficits without falling into recession.

Given the underlying strength of its economy, its large current account surplus, and its central role in the European Community, the Federal Republic of Germany has a critical part to play in facilitating the necessary adjustments so that sharp dislocations in the world economy can be avoided. The substantial appreciation of the DM relative to the dollar suggests that the FRG cannot continue to count on merchandise exports to the United States, particularly of luxury automobiles and other high-priced or high-tech goods, to provide the basis for growth in the economy. Indeed, in the current world environment, the long-standing policy of export-led growth no longer appears to be a feasible option. A balanced program of monetary and fiscal measures to promote domestic growth, along the lines summarized in this report, represents a reasonable alternative.

At the same time, multilateral initiatives will be necessary to remedy the structural imbalances in the world economy. This will involve redistribution of the costs of the West's mutual security system, consistent with the relative economic strength of the nations which make up the system. It will also require a multilateral approach to the Third World debt crisis that will fully engage the major surplus countries, including the FRG, in a process to facilitate a resumption of economic growth in nations overburdened by their foreign debt obligations.

These measures should make it possible for the FRG current account surplus to be reduced in a steady and responsible manner. Reducing the surplus will serve the best interests of the world trading system, on which the economic health of all trading nations depends.

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