Germany through inflation and Recession

An Object Lesson in Economic Management 1973–1976

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"Political economy, considered as a branch of the science of a statesman or a legislator, proposes two distinct objects: first, to provide a plentiful revenue or subsistence for the people, or more properly to enable them to provide such a revenue or subsistence for themselves; and secondly, to supply the state or commonwealth with a revenue sufficient for the public services."
Adam Smith, *The Wealth of Nations*, 1776, Book IV

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Introduction

THIS study investigates in some detail how the Bundesrepublik dealt with the effects on its economy of the world recession in the mid-1970s when unemployment reached over one million, without falling back on large scale interventionism, nationalization and controls of prices, wages, profits and investments; so far the principles of the social market economy remain intact, though undergoing evolutionary adaptations to new conditions.

The tenets of a free, but socially orientated market economy are repeatedly asserted by Federal Ministers; they were carried by the SPD resolutions at Mannheim in November 1975. Despite world recession (from which Germany could not insulate herself), industrial production has been growing over the last 10 years at twice that of the U.K. while inflation in 1975 was one quarter of this country's. Strikes in 1970–75 in terms of working days lost were less than one-tenth of those of the U.K. and real GNP per head approximately 50% higher[1], no more housing shortage, and, as a result of these successes, there is an economically less envious, divided and class conscious society in Germany today.

We are, however, not discussing in this study the popular opinion that there is much better management and greater industriousness of labour in Germany. While this is difficult to quantify, it is true that industrial relations are better in Germany, with an absence of trench warfare between management and labour which in the U.K. goes back to the inter-war years and which unfortunately persists to this day. Social amenities at work, too, are better in Germany, the near-absence of ideological and political motivations at shop floor levels, and the attraction of professional management as a career – encouraged by the curriculum at college and school – must have had their effects over the last 25 years. To train for business in Germany is a primary aim, not a second best.

The study starts with a survey of German thoughts and ideas

[1] This estimated excess of around 50% of the per head GNP of the BR over the UK can only be taken as an order of magnitude. The 1975 OECD report on Germany estimates this excess at over 80% by applying the average 1975 Sterling/DM exchange rate to the respective per head figures. This without doubt overstates the excess and ignores price relativities and the different compositions of the GNP in both countries. The above compromise estimate of a 50% excess, now often quoted in Germany, is more realistic though it implies an undervaluation of Sterling against the Mark of around 25% over the whole range of GNP.

from which German economic policies largely stem. This includes the teachings of the Freiburg school of social scientists, particularly W. Eucken and F. Boehm to which must be added Professor Erhard (the originator of the 1948 currency reform), Professor Mueller-Armack, W. Roepke and A. Ruestow. Post 1948 thinking was also greatly influenced by two important epigones of the Austrian school of economics, viz. L. von Mises, the most outspoken critic of inflationism and interventionism of his generation (he died aged 92 in 1973), and his famous pupil F. von Hayek.

In step with the evolution of the concept of the German social market economy, a new generation of economists and social scientists has emerged, defending and developing their teachers' principles. Where appropriate their voices have also been given prominence – not an easy task, due to the very large number of papers and books that exist.

Whilst this study is concerned with the social liberal philosophies and principles of economic management in post war Germany, it must not be overlooked that there are also intellectual forces at work calling in question these achievements.

Though some of the German ideas may not sound precise and perhaps are a little unfamiliar to mathematically orientated Anglo-American economists, in the words of Mueller-Armack:

> the attempt to achieve common ground social goals on basis of personal, political and economic freedom may be regarded as a constructive synthesis and example superior both to labour-socialism and nineteenth century laissez faire.[1]

[1] *In Wirtschaftsordnung and Wirtschaftspolitik*, 1966.

Summary of Principal Economic Policies 1972–75

1. The Bundesbank (BB) pursues a restrictive policy from 1972 and by March 1973, gains full control over the monetary base. Since 1973, the monetary base and money supply has increased at moderate and nearly even rates. The monetary base target is now officially announced for each year in advance, viz. 8% for 1976. The chief target is the quantity of money and not the level of interest rates.
2. Both Government and BB stated that internal cost increases, particularly high wage agreements and their recovery in prices will not be underwritten by a corresponding expansion in the money supply, even at the cost of unemployment, lower profitability and bankruptcies. Gradually the market will again have to determine price relativities flanked by appropriate monetary policies.
3. The Government assists necessary structural changes in the economy and readaptations of resource misdirection which were caused by inflation, but does not rescue firms in difficulty simply for keeping untenable work places open. Mobility is encouraged.
4. The Government uses fiscal measures to prevent the recession from falling into a 'secondary' self-perpetuating deflation, this policy being supported by the BB, but not at the cost of renewed inflationary money creation.
5. There are large deficits in the public sector in 1974 and 1975 as anti-cyclical supports for the economy. But plans were agreed in the autumn of 1975 gradually to reduce this, mainly by expenditure cuts, to approximately one third by 1979. However, the budget deficit is not to be financed by raising the money supply.

6. The Federal Government's economic report for 1976, published at the end of January 1976, reaffirms in strong language the principles of a free market: policies for the restructuring of part of the German economy, it states, must continue, but such policies must not abrogate the self-steering of the economy via market forces. Government direction of investment is bound to hinder the ability of the economy to adapt to the ever-changing market and production conditions. Policies for restructuring shall primarily assist technical progress and the mobility of the factors of production, labour and capital. A selective growth policy and interference in wage negotiations is strictly to be avoided. Only an appeal to the social partners may be made to have regard to the differences in market structures and requirements in order not to endanger in weak branches employment opportunities and mobility. This is supported by the BB's determination not to exceed the growth in monetary base by 8% on average thus avoiding stimulations of dangerous cost and price rises.
7. A sophisticated statistical tool has been forged to divide the total budget deficit into a 'cycle neutral' (full capacity utilisation deficit[1]) and a contra-cyclical component. This makes for a more intelligent and realistic appraisal of budgetary policies.

1. See Chapter IV for a discussion of this concept.

CHAPTER I

The Evolution of the Social Market Economy

a. The historical background

THE GERMAN industrial revolution, compressed into the short space of the last third of the nineteenth century, was not paralleled by an acceptance of economic liberal ideas. The advice to the King of Prussia, allegedly given by Prince Hardenberg, his Chancellor, at the beginning of the nineteenth century: "We must do the same from above as the English do from below. . . "sums up neatly the basic totalitarian thinking on economic matters up to 1918 and beyond.

Germany was first among European nations to nationalise or communalise railways, public utilities and parts of basic industries. The State founded banks, favoured strong cartels and business mergers as deliberate means to curb or control competition. Crafts were joined into compulsory guilds. 1879 saw the introduction of wide-ranging protection against imports. The State remained the owner of large agricultural and forestry domains and became increasingly the partner in mixed private and public businesses.

Underlying this collectivism was a deep distrust of the morality of competition and of a free pricing system, and a belief that collectivism would make the nation strong. Regulation of the economy "from above" through cartels, large business concentrations and primarily non-profit orientated State enterprises was meant to introduce concepts of planning and regulation into business life modelled on the traditional discipline and principles of the Prussian State.

These trends were strongly supported by the academics of the "historical school" of economics: men whose names are largely forgotten in all but Germany, e.g. Roscher, Knies, Hildebrand and

Schmoller (1839-1917). They had immense influence on official thinking, policy making and administration. They denied the validity of economic analytical reasoning (as it developed in England and Austria) and. . .

> saw all economic phenomena as unique, determined by their own historical development. . . Refusing to believe in general laws, the historical school had the special attraction that its method (painstaking historical research) was constitutionally unable to refute even the wildest of utopias.[1]

Contemptuous of classical economics and of the analytical Austrian school – which was strictly excluded from German Chairs – Schmoller, in his two-volume foundations, congratulates his country that "hawkers" economics has been turned in Germany into a moral and political science, making the nation strong and freeing it from the immoral and insidious aspects of competition and the free pricing system. In the view of this school – for Germany so fatally powerful – there are no other laws of economic life than those made by men (civil servants, politicians, leaders of cartels, etc.) and the economist need only rationalise them, describe their institutional and historical development, and help to put them on the highest possible ethical plane.

This economic dirigisme of Imperial Germany – called by an American, Elmer Roberts, in 1913 "Monarchical Socialism"—was brought to a climax in the siege economy of 1914-1918, and many of its features were subsequently taken over by the Weimar republic. Although analytical economics had by now been recognised in Germany, many of its exponents attempted a fusion between free market ideas with planning ideologies. Typical of this trend was the setting up by the Government in 1927 of a commission of enquiry (Wirtschaftsenquete) into all branches of industry, commerce, banking and trade. It produced some 60 volumes of detailed analysis of the structure of the German post-1918 economy which should form the basis for planning by Government in conjunction with unions and employers.

But these efforts were overtaken by the 1929-33 world depression which the Germans tried to meet with more and more interventions into what had remained of market forces. The cartels were used by the State to enforce its political pricing and allocation policies, the banks were taken over, the unions became organs of the State to set "political" wages. More and more all-embracing regulations of the economy were introduced, e.g. a draconian control of foreign exchanges and capital flows, and by

1 von Hayek, *The Trend of Economic Thinking*, Economica 1933.

1933 the Weimar republic had in reality accepted State socialism. The German economy was therefore ready to be taken over by Hitler.

Gustav Stolper, the liberal editor of the *German Economist* (*Deutscher Volkswirt*) described in 1930 – when it was not yet too late – Chancellor Bruenings's measures as being between Marx and Hitler, and in retrospect he wrote in 1940, while in exile:

> Imperial Germany laid the foundations for the siege economy of 1914–1918, for the interventionist experiments of the Weimar republic, and lastly for the system of National Socialism.[2]

The economic policies of the Third Reich – though complex in details – were simple: The State and party regulated all aspects of economic life and a siege economy was established long before the war. Industry and trade – in appearance still partly in private hands – was instructed what and for whom to produce, where to invest, at what prices to sell and to buy. Free choice of work place was abolished in favour of direction of labour, and workers' passbooks issued. Compulsory labour at nominal rates of pay was introduced. Raw materials were allocated and foreign trade and currency flows even more tightly controlled than during the last years of Weimar. Overfull employment was financed through treasury bills via State banks, to be re-discounted by the Reichsbank. Wages and price stops, profit controls and subsidies aimed to camouflage the resulting inflation. By the end of the 1939-45 war money volume had increased nearly ten-fold since 1933, but the coercive controls suppressed the inevitable effects until the collapse of the regime. To sum up the economics of this period in the words of Hitler in 1941:

> basically National Socialism and Marxism (viz. Soviet Communism) are the same.[3]

The disintegration of Germany and the near-destruction of its industrial base put a final end to the totalitarian and State socialistic traditions of the past. While the Weimar republic still looked back, partly nostalgically, to Imperial Germany, the new State (later Western Germany) cut all its ties with this economic history and a second industrial revolution had to start afresh to rebuild the country, though this time with a significant difference. Paraphrasing Hardenberg's advice to his King, this time the new beginning was to be made not from above, but from below, like the English did it in the eighteenth century when the industrial revolution pushed ahead in parallel with individual freedom and a competitive, anonymous and spontaneous pricing order.

But this must on no account be confused with a return to crude

2 G. Stolper. *Wirtschaftsgeschichte*, Tuebingen 1966 (Mohr)
3 Von Hayek, *The Road to Serfdom*, Routledge, Kegan & Paul, 1944.

laissez-faire. The earliest pronouncements on the social market economy emphasise the social content and the aim of a synthesis of market order and social protection. What it amounted to was this: *Without social protection no market order and without market order no social protection.* This thesis was developed over the years and now embraces all aspects of a more humane social order, which W. Roepke, one of the original theoreticians of the new thinking, describes as an order beyond demand and supply, or as a *civitas humana*, the title of one of his books.

b. The Main Principles of the Early Social Market Economy[4]

The objective of the policy was the establishment of a competitive order (in contrast to a corporate or centrally directed economy) letting freely determined prices steer the allocation of resources and the satisfaction of the consumer. The writers saw the main task being to make the price mechanism work. All economic policies were bound to founder if the paramountcy of prices as an efficient allocator of resources is ignored. They argue that this is the strategic core which governs the whole, and which requires the concentration of all forces. Its central position must on no account be relinquished though the competitive order must be filled with a social content of common ground. To these writers, the social market economy is an all-embracing style covering the whole of society giving a common imprint to the community's social life.

They set out to show that the competitive order aims to develop the spontaneous forces and vitality of man, but it must also care that these forces do not work against the common interest of a free society. Further, this system is the only type of order which contains the power of egoism, while in command economies there are no limits to the arbitrariness of bureaucrats or self-imposed elites. It also safeguards the interdependence of policy decisions – social, legal and economic – within the market order.

There are two constituents of the competitive order. First, a stable currency is a prerequisite for the economic calculus. It avoids misallocation of resources, enables growth within the technical and physical constraints of the economy and avoids social conflicts and confrontations.

All endeavours to create a competitive system are in vain as long as a certain stability of the value of money is not safeguarded. The principle of giving currency policy a special rank within economic policy has a particular significance. Through stability of the value of money, it is possible to fit into the economic process a

[4] W. Eucken *Grundsaetze der Wirtschaftspolitik* 1952; J. C. B. Mohr, Tuebinger 1975, *Die Grundlagen der Nationaloekonomie*, 8 editions 1939–1949, Springer, Berlin 1965.
A. Mueller-Armack, *Wirtschaftsordnung and Wirtschaftspolitik*, Rombach, Freiburg, 1966; "Genealogie der Sozialen Markwirtschaft" Paul Haupt, Bern 1974; (with L. Erhard) *Soziale Markwirtschaft* Ullstein, Berlin 1972.
F. Boehm, *Freiheit und Ordnung in der Marktwirtschaft*, Ordo 1971.

serviceable steering instrument. Just as with the competitive order, a good money order should function as automatically as possible, otherwise wilful interference by the State will lead to its abuse in order to cover up the power struggles of the various economic interest groups: inflation is the result. The industrial economy requires stable money values for its proper functioning.

Second, private property is a precondition of personal freedom and competition. Collective property of large sectors of the economy leads to central direction and misallocation of resources due to a non-economic calculus, and it raises social problems which cannot be solved. But this emphasis on private property does not imply attitudes associated with early capitalism. The Basic Law[5] (Grundgesetz) in paragraph 14 specifically states: "Private property has its obligations. Its use should also serve the public weal." Liability for the consequences of wrong business decisions based on private property are not to be transferred to the State. "Freedom and risk are thus inseparable."[6]

Since private property is a pre-condition for the competitive order, this order in turn is a pre-condition if private property is not to lead to economic and social abuses. Collective property to the exclusion of private property causes power concentrations which threaten and oppress human freedom. L. von Mises wrote in 1922:

> Liberalism (in contrast to Totalitarianism) champions private property in the means of production because it expects a higher standard of living from such an organisation, not because it wishes to help the owners. The surplus in the production of goods through a liberal order concerns even the poorest and it is by no means the particular interest of the rich.[7]

These thoughts were echoed by von Hayek some 40 years later,

> Liberalism (again in contrast to Totalitarianism) thus derives from the discovery of a self-generating or spontaneous order in social affairs, an order which made it possible to utilise the knowledge and skill of all members of society to a much greater extent than would be possible in any order of central direction and the consequent desire to make as full use of these powerful spontaneous ordering forces as possible. . . a spontaneous order of human activities of much greater complexity will form itself than could ever be produced by deliberate arrangement.[8]

Many of the older authors have been ridiculed in the United Kingdom, e.g. Lord Balogh in the *Guardian* of May 22, 1972 attributes to the Austrian school "a sort of lunatic logic buttressed by bogus evidence," yet their thinking contributed much to the German economic revival and accomplishments. In this connexion a passage in Lord Robbins' autobiography (p. 234) may be quoted:

[5] See C. II
[6] Von Hayek, *Economic Freedom and Representative Government*, – p. 17.
[7] L. von Mises, *Die Geme inwirtschaft.*
[8] F. von Hayek, *Studies in Philosophy, Politics and Economics.* – p. 162.

On the day of the resignation of Lord Thorneycroft I was standing in my Club, reading the mid-day tape, when one of the younger economists observing me and presumably attributing to me some influence on the policy of the preceding autumn, turned to his companion and said in a loud voice, obviously intended to reach my ears: 'This is the best news for years. It is the death of the Quantity Theory of Money'.

One wonders what this economist would say now, 20 years after, when these ideas have also had a revival in this country and contributed to the German success.

c. The Role of the State

The competitive market is an economic order which can only be generated and realised by the State. The State, however, is to be devoid of liberty destroying instruments or of delegating its market coordinating functions to conflicting corporate interest groups. The main principles to be observed by the BR orientated towards the social market economy during this earlier period (up to the 1960's) are:

Full Employment, but not to be pursued at any cost. When Eucken laid down this maxim in his posthumously (1952) published *Principles of Economic Policy*, he did not only think of the inflationary consequences of Full Employment policies, but of the distorting effects likely to occur in the allocation of scarce resources. Similar ideas had already been expressed by von Hayek in the 1930's though their importance was only realised some 30 years later.[9]

Monopoly policies are designed to limit or dissolve economic power concentrations, though oligopolistic tendencies have to be recognised as one form of the competitive system of a technically innovating society. Given effective monopoly legislation, one can expect oligopolists broadly to behave analogous to the principles of the competitive order. In this sense monopoly control acts "prophylactically" (Eucken) and integrates the oligopolists into the basic competitive market order.

The State is responsible for creating the framework for a workable competitive order, but it is not to run the German economy through direct controls of prices, wages, profits, dividends and investments.

This does not prevent the State using market forces steered through fiscal measures from rendering social and environmental services generally expected by the citizen in an expanding economy where private choices are not excluded.

9 F. A. Hayek, *Prices & Production*, Routledge 1931.

Economic and social policies of the State are complementary to the free market when operating through the market, not against it. It follows that economic policies must show some continuity and be of one piece. (Auseinem Guss).

The thinking of this period may be summed up in the words of F. Boehm:

'The competitive market order is an order or arrangement of co-ordination. This order must establish a broadly based freedom for the individual and a widely dispersed economic power structure. The market structures for demand and supply are to be distributed over many hands and the arbitrariness of collectivism is excluded.[10]

These broad principles served the German economy well until the mid-sixties when new internal and international factors required adaptations and sophistication of the basic thoughts.

A few figures may illustrate trends between the early fifties and the mid-sixties (UK figures in brackets):[11]

Growth of output per employed person p.a. (adjusted for shift from agriculture)	4.8%	(2.2%)
Investment ratios of GNP	25.0%	(15.0%)
Rise in Consumer prices p.a.	1.9%	(3.7%)
in 1975	6.0%	(24.0%)

d. The thinking since the Mid-1960's

The new factors emerging in Germany and calling for solutions based on social market principles were:

1. The frequency and deepening of the trade cycle;
2. Accelerating inflation, largely imported from abroad and only with difficulty (until 1973) counteracted by the BB.

As the DM was undervalued since 1964, prices were left to move up and the public sector supported this through pro-cyclical policies of rising expenditure. At the same time, home generated inflation was added to imported inflation. Between 1963 and 1967, prices in Western Germany rose by 12% over the whole period – a rise which was considered to be totally unacceptable. In addition, problems of energy use and regional imbalances, environment issues and a falling behind in the provision for communal needs and the avoidance of social ills in the face of rising private affluence had to be faced.

The evolving new principles formulated by K. Schiller[12] divide the economic tasks of the state into two groups: first those involving the provision of the competitive market order to fulfil the micro-economic goals of the allocation of scarce resources and secondly the provision of a co-ordinating framework to guide

10 F. Boehm, *Freiheit und Ordnung in der Marktwirtschaft Ordo* 1971
11 It is a common belief that the postwar recovery in Germany is primarily due to huge Marshall aid. In fact the BR received only approximately two thirds of the amounts received by the UK. Apart from Marshall aid, the UK also received large loans, etc., from other countries, though strict comparisons are difficult to make. In Germany the counterpart funds of Marshall aid were placed into a special fund (ERP) which still exists and played a major role as a source of investment funds in later years.
12 K. Schiller, Preisstabilitaet durch globale Steuerung der Marktwirtschaft; J. C. B. Mohr,

through market forces, the macro-economic interdependentaims of high employment, price stability and growth. This led in Germany to the concept of the "Magic Polygon," the corners of the polygon representing goals not always *prima facie* fully compatible with each other. For instance, the Magic Triangle represents the aim for high employment, price stability and balance of payments equilibrium; by adding growth as a further aim, the magic triangle becomes a magic quadrilateral.[13]

K. Schiller states that:

> the optimal co-ordination of steering measures consists of the combined application of the principle of self-steering for the micro-relations and the global steering of the macro-relations. There is no contradiction in logic, though in reality conflicts will arise. But this is the only way to safeguard the market economy against administrative direct interventions.[14]

The reconciliation of goals within the magic quadrilateral was put into legal form in paragraph 1 of the Stabilisation and Growth Law of 1967 which instructs the Federal and the Regional (Laender) Governments:

> to consider all its economic and financial measures within the requirements of economic equilibrium and the competitive market order to achieve stability of prices, high employment, growth and equilibrium in the foreign balance.

Paragraph 2 instructs the Federal Government to submit each January to Parliament an annual economic report which must include:

> The Government's attitude to the annual report by the independent council of five academic experts (Sachverstaendigenrat).
>
> A projection for the coming year of the Government's economic and financial goals.
>
> A clarification of the economic and financial policies contemplated for the coming year in macro-economic terms.

Paragraph 3 stipulates that in case of possible conflicts between the goals in para. 1, the Government must provide and explain orientation data to the social partners to facilitate a concerted action (Konzertierte Aktion) to avoid upsetting the unity and interdependence of actions of State, unions and employers.

Introducing global steering and concerted action had already been discussed by the scientific advisers to the Economics Ministry in 1956 – the heydays of the economic miracle – because in their opinion the competitive order of markets needs the support of a trade cycle policy to achieve the three postulates of the magic triangle – price stability, high employment and foreign

13 von Eynern, *Grundriss der politischen Wirtschaftslehre*, Koeln 1968.
14 K. Schiller, *Preisstabilitaet durch globale Steuerung der Marktwirtsschaft*, Tuebingen 1966.

equilibrium. They considered that fiscal measures must also help markets to adapt to structural change.

Even the relatively mild inflation in Germany which lasted until the late 1960s had led to misdirection of resources and imbalances in branches of the private sector. As inflation increased during the 1970s, further misdirection increased. A law passed in 1968 (Principles for sectoral structure and regional economic policies) states:

> Government policies must ease and support structural change. . . The mobility of factors of production must be secured, even if this implies disappearance of in the long run unprofitable firms. . . structural change has to be encouraged and the climate for structural changes improved in order to avoid such adaptation crises.

In the words of the present Minister of Economics:

> There are two pre-conditions for success. First, effective competition as a motor towards structural change, and secondly a favourable social climate which encourages such a change.[15]

The 1967 Law gave rise to a large academic literature suggesting that this Law spelt the end of the social market economy. One commentator – H. O. Lenel – in a paper published in 1971, even asked: "Have we still a social market economy?"[16] From the vantage point of the UK, one of the most interventionist countries in the Western industrial world, these criticisms might appear to be of a perfectionist and purist character. However, many German writers are anxious to demonstrate that their reservations are fundamental, and that purism is in effect equivalent to the upholding of unadulterated principles.

The fierceness of the attack may also have been motivated by the trauma of the authoritarian German State of previous generations and possibly also by the examples of contemporary failures of interventionism in other Western countries and in the DDR.

The main lines of critical thought were formulated by a number of professional economists, of whom E. Hoppmann, H. O. Lenel, E. Tuchtfeldt and C. Watrin are probably representative of many others.[17]

The original concept of the social market economy implied a spontaneous order without a concrete goal, but consisting of a multitude of individuals, households and firms making millions of spontaneous decisions constrained only by the rule of Law. The new principles attempt to create instruments to achieve concrete and numerically defined collective aims. There is a danger that the social market economy may be replaced by a rationalistic constructivism and by quantitative plans originating on an economic drawing board, or from econometric models. C. Watrin

15 *Collected Speeches 1974/1975*. Bonn 1975.
16 H. Lenel, *Haben wir noch eine soziale Marktwirtschaft?* Ordo 1971.
17 E. Tuchtfeldt (Edit.) *Soziale Marktwirtschaft im Wandel*, Nine papers by Mueller-Armack, Hoppman, Watrin, Rupp, Willgerodt, Woll, Tuchtfeldt, Issing, Schueller; Rombach, Freiburg, 1973. F. von Hayek, *A Tiger by the Tail*, Hobart Paperback, I.E.A. 1972; *The Counter-Revolution of Science*, Economica, 1941-44; *The Road to Serfdom* University of Chicago Press. 1944; *Full Employment at any Price?* I.E.A. 1975

interprets this change of concept:

> One has left the concept of the market economy as an order which is not based on collective goals, but on common rules of the competitive game and is replacing it by the idea that certain pre-determined goals ought to be commonly pursued by all social partners.

E. Tuchtfeldt criticises the period after 1967 as a to-and-fro of measures because of deviations of the actual aggregates from their quantifications in the magic quadrilateral. This failure is due, in his view, to the unreliability of quantitative prognoses on which global measures have to be based, even though these prognoses by the Sachverstaendigenrat (Committee of Five Wise Men) are submitted in several variants dependent on alternative assumptions. One is tempted to compare these vacillations, which Professor Tuchtfeldt condemns, with the tempestuous economic environment of the United Kingdom: nationalization, de-nationalization, re-nationalization or the hammer blows on the economy by the violent swings in public policies from expansion (1971/72/73) to contraction (1973), back to expansion (1974) and back to contraction (1974/75) with even more severe contraction threatening for 1976.

Concerted action – para. 3 of the Stabilization and Growth Law – is challenged as incompatible with the "true" social market economy. H. O. Lenel observes that the leniency towards business fusions and bigger aggregates makes it easier for the Government to bespeak global aims. By having fewer, though bigger, partners round the table, the greater is the hope of agreement or enforcement of basic goals.[18] H. Rupp, however, advises caution when advocating drastic controls of business fusions because such controls might introduce through the back door dirigiste elements into the "fine nerved self steering of the competitive system"[19]"

Summarising briefly, in the view of the *critics*, the original concept of the Stabilization and Growth Law of 1967 is the global directing of the economy and indirect intervention into income formation through concerted action. This intervention, camouflaged as "moral suasion," appears to be based on the view, widely held at the time that wages (and inflation) are determined by trade union power and by "horse-trading" between the social partners. Concerted action would succeed *ex ante* to harmonise the conflicts between the social partners in conformity with the pre-set targets of the Government and spelled out quantitatively in the magic quadrilateral. In fact, the critics point out, this harmonization has not succeeded. In this context it may be

18 E. Tuchtfeldt (Edit.) *Soziale Marktwirtschaft im Wandel*, Ibid.
19 Ibid.

significant that the fundamental criticisms of the 1967 Law were made before 1973, when the BB at last succeeded in obtaining strict control over the money supply (see chap. III) and policies moved into a new direction.

Reading through this very large, critical literature, the outsider gains *superficially* the impression that since 1967 West Germany was again back on a path towards a largely planned economy, the State deciding on most aggregates and setting specific and detailed economic and social goals.

In fact, it would seem that the 1967 Law – admittedly unsatisfactorily and vaguely formulated – mildly attempted to improve the framework for the multitude of individual decisions by households, firms, unions and the odd 25,000 public authorities in terms of high employment, price stability (which can, but ought not, to include steady though not accelerating price rises), foreign equilibrium and growth. This modest steering only affects the frame within which the freedom of the individual remains quite unaffected and intact. Reading through the writings of (e.g.) W. Eucken or A. Mueller-Armack, one cannot see any fundamental deviations and one can cite many passages in their writings which would seem to confirm these steering ideas – as long as they are in conformity with the overall interdependence of the basic free order, liberty under the rule of law.

Even Sir Karl Popper, the most ardent protagonist of the open society and much quoted in Germany, does not see in fiscal and monetary controls of the trade cycle the equivalent to totalitarian, holistic planning of society by the State.[20]

An analysis of Chancellor Schmidt's recent pronouncements gives some indication of current policy; controls of prices, wages, profits and dividends are ruled out; nationalization is considered as irrelevant; private profits are needed to provide employment and growth and any direction by the State of private investment and capital funds is quite unacceptable.

In an interview with the Guardian [21], he (Chancellor Schmidt) expressed scepticism, if not dismay, at the interventionist and specific directing policies which were pursued in the United Kingdom under both recent Governments.

It must, however, be conceded that the Stabilisation and Growth Law and West German policies have not prevented divergencies from the annual quantitative aims. Professor Watrin and M. Kern have analysed these deviations for 1967 to 1972.[22]. It is significant that the greatest errors occured in price trends, no doubt due to the

20 *The poverty of historicism* pp. 58-70, or *The Open Society*, vol. 1, p. 158 or vol. 2, p. 348.
21 September 30, 1975.
22 C. Watrin, *Globale Wirtschaftssteuerung und Einkommenspolitik* Ordo *1973;* and M. Kern, *Konzertierte Aktion*, Institut fuer Wirtschaftspolitik, Universitaet Koeln, 1973.

hesitant and belated revaluation of the DM and the inability of the BB to neutralise the vast and unpredictable foreign currency flows into Germany. Also the unclear formulation of the magic quadrilateral may have given rise to the setting of uncompatible and unsustainable quantifications of high employment, price trends and growth. But perhaps it would have been over-ambitious and controversial to expect the drafters of the 1967 Law to assimilate Professor Friedman's definition of a "natural rate of unemployment"[23] into the high employment concept and to constrain growth to "growth of productive potential".

If, however, high employment and growth in the 1967 Stabilization and Growth Law were interpreted in this way as "natural rate of unemployment" and growth of productive potential – both exogenously determined by variable technical, institutional and sociological factors – then the goals of the magic quadrilateral need only be contradictory, if the control of the money supply by the BB is prevented and the DM is not floated against the Dollar. Viewed from the BB obligation until early 1973, to support the Dollar, the magic quadrilateral looked indeed magic and difficult to achieve, but once the BB was released from this obligation, in March 1973 (see chap. III,) the four aims became no longer incompatible – particularly if interpreted in the above way. Such a re-interpretation may be read between the lines of the paper by C. Watrin [24] in Ordo 1973 (presumably written before the Spring of 1973) and more outspokenly by O. Issing [25] also most likely written before 1973.

Once the BB gained control over the monetary base and the money supply in 1973, the four aims become realizable. But due to past inflation, it took not only time but incurred the unavoidable cost of a level of unemployment temporarily above the "natural" rate. It would appear that the BB, by pursuing policies of a steady but moderate growth of the money supply, has gained great influence in the Stabilization Law's "concerted action", though officially the BB is not a partner.

If this is a correct appraisal of the BB's present policies, then it is not unreasonable to expect that the macro-economic goals now implicit in the Stabilization and Growth Law will harmonize a sustainable level of employment [26], relative price stability and growth of the economy within the limits of productive potential, to the exclusion of unendurable inflationary stimulations.

To answer the purists' reservations that the Stabilization Law is abrogating the social market order principles, Professor Mueller-

23 M. Friedman, *The Optimum Quantity of Money* and other essays, MacMillan 1969; *Capitalism and Freedom*, Chicago University Press, 1962; *Unemployment versus Inflation*, I.E.A. 1975; (Note: There are now in Germany numerous appraisals of M. Friedman's Theories, e.g. K. Ketterer, *Probleme der Neo Quantitaets-theorie 1975* and G. Honeck, *Friedman Plan und potentialorien tierte Kreditpolitik 1975*).

24 C. Watrin, *Globale Wirtschaftssteuerung und Einkommenspolitik*, Ordo 1973.

25 E. Tuchtfeldt (Edit.), *Soziale Marktwirtschaft im Wandel*, ibid.

26 The word sustainable is used here in preference to natural. See S. Brittan, *Second*

Armack must be quoted again:

> The framework of the State must provide the foundations for the interdependent economic system. . . and must give stability of money, high employment and growth.[27]

Assuming the BB continues to succeed in the strict control of the growth in the money supply, the controversial Stabilization and Growth Law may lose some of its importance. The Freiburg imperative (the German shorthand for this school's socio-economic principles borrowed from Kant's categorical imperative of a moral law which admits of no exceptions) may in future be flanked by the Chicago (Friedman) imperative. The Eucken philosophy may thus reappear after 25 years in a more sophisticated form, appropriate to the changed conditions of a later age, though as self evident as ever.

e. The Constitutional and Legal Foundations

The principles of the social market economy have been anchored in legal instruments.

1. The Basic Law (*Grundgesetz*)

When the basic law was formulated it did not specifically stipulate the economic order as a social market economy, though its economic tenor is distinctly liberal and social. The law givers confined themselves to principles which forbid both a "command" economy and an extreme *laissez-faire* economy. The constitutional court decided in 1954

> that the basic law is not a guarantor of the competitive social market economy. The present economic and social order is not the only possible order under the constitution. It can be replaced by other orders though they must not be in conflict with the fundamental rights and freedoms of the individual as laid down in the constitution.

This view has, however, been challenged over the years by many writers; for instance H. Rupp asserts that this alleged neutrality is false and that a constitution whose basic principle (para. 1) is the freedom of the individual cannot exclude the economic order from this all-embracing principle.[28] According to this interpretation of the constitution, the basic rights (para. 1 to 19) of the Grundgesetz instruct the State to create and safeguard the conditions within which in our present day environment human individual freedom is made possible. Since competition is an essential condition of freedom, its protection by the State is legally legitimated and therefore integrated into the constitution. An

27 A Mueller-Armack, (with L. Erhard) *Soziale Marktwirtschaft*, Ullstein, Berlin, 1972.

28 E. Tuchtfeldt (Edit.), *Soziale Marktwirtschaft im Wandel*, Nine papers by Mueller-Armack, Hoppman, Watrin, Rupp, Willgerodt, Woll, Tuchtfeldt, Issing, Schueller. Rombach, Freiburg, 1973.

amendment in 1967 of paragraph 109, instructing Bund and Laender to take due account in their fiscal administration of the requirements of overall economic equilibrium would tend to confirm this newer interpretation of the Grundgesetz.

2. *The Act against Restriction of Competition.*

To discuss this immensely important, but very complicated and many times amended Act would fall outside the frame of this study. Suffice it to give the barest outlines:

It sets out a framework for the market processes and secures competition. It forbids monopolies and cartels, or at least controls them. It controls mergers in order to safeguard economic and social freedom, and to give consumers through improved competition greater price flexibility.

It aims to give smaller enterprises greater chances to compete with the giant firms and it is directed towards a wider dispersion of incomes and wealth, and towards greater mobility of factors of production and distribution.

3. *The Stabilization and Growth Law (1967)*

The important features have already been discussed in I. above. This law also provides for anti-cyclical money transfers from the Government to be frozen at the BB during booms and to be released during recessions. It sets up a trade cycle advisory body (Konjunkturrat) and provides for flexibility in income determined taxation rates. The law requires that the statutory annual report and recommendations of the Council of Experts (Sachverstaendigenrat) as well as the annual economic report by the Government should include comments on the experts' report. (The details were made law in 1963). The Stabilization and Growth Law also provides for the biennial subsidies report, which has to group subsidies as between subsidies to maintain existing economic structures (largely agriculture), subsidies which help market orientated structural changes or adaptations, or are dependent on such changes being undertaken, and finally subsidies to raise productivity. Subsidies simply to conserve unprofitable enterprises and maintain employment in such enterprises do not exist. There are also personal subsidies to encourage saving and for the payment of rents, for people in need and living mainly in low cost housing.

CHAPTER II

The German Economy 1973–75

a. The Context

THE recession in West Germany has its origins in mistakes and missed opportunities since the end of the 1960s, which threatened to compromise the social market economy. If one cause may be singled out, it was the inability of the BB to stem effectively the import of inflation from abroad because of the obligation to support the Dollar and other weak currencies which sought for a haven in the country of "the economic miracle". This influx of money, coupled with an undervalued DM and an unsustainable export surplus, led to domestic inflationary tensions which eventually *had* to be resolved at the cost of a recession which synchronized worldwide.

> You have no alternative to biting the bullet sooner or later. The only question is when. (M. Friedman in a letter to *The Times*, December 6, 1972)

The attraction of West Germany for foreign money, chiefly dollars, can be seen from the increases in the BB foreign reserves:

Increase in BB foreign reserves
(in Billion DM)

1970	+ 23.0
1971	+ 14.8 (Smithsonian new parties)
1972	+ 16.9
1973	+ 26.4 (Jan. to March + 19.9 Floating started March)
1974	− 1.9
1975	− 2.2

As the BB was hardly able to neutralize this influx of liquidity into the banking system, let alone the direct foreign money flows into the non-banking sector, rising inflation in West Germany could not be prevented. Though it may sound strange to British ears to hear of inflation in West Germany at a rate of between one half to one quarter of the UK rate, qualitatively the German rates were bound to generate the typical economic and social consequences resulting from the faster rate of growth in money supply than in output.

The distributive strains of the division of the GDP between the social partners increased. Inflationary expectations were built into wage negotiations and, due to a plentiful money supply, were met by rising prices and profits. This in turn caused further escalation still financed by the rising money supply – primarily based on the foreign money inflows. The predictable misapplication of resources ensued. This rising money supply also enabled the Government to increase its demands on the productive potential, largely based on the inflationary rises in tax incomes. Until the end of 1973 inflationary expectations were high, only occasionally for short periods dampened by the brief floating in 1971 and the (insufficient) uprating of the Mark after the Smithsonian agreements. The effect of inflationary expectations or money illusion – expressed in the vertical Phillips curve – now much discussed in contemporary monetary literature, was already well described by von Mises in the early 1920s in his books – *Die Gemeinwirtschaft* (p. 485) and *Theory of Money* (p. 204), and in a lecture on the world slump, given in 1931.[1]

But in West Germany, sooner than in other industrial countries, it was realised by practical men that employment can only be maintained at an over-full level by more and more inflation and accelerating price rises. March 1973 was the turning point, when the BB gained strict control over the money supply and the unavoidable stabilization recession followed: in principle not very different from the stabilization crises in Austria and Germany of the 1920s, though of course of a milder and less destructive nature. By the turn of 1974/75 it would appear that West Germany was on the way to success. It took – due to the handicap of the BB – six years (from 1967 to 1973) to forge the missing link with the controversial Stabilization and Growth Law. Control of money takes some magic out of the quadrilateral.

One final point before discussing the details of each year, 1973 to 1975. It is now often said that West German policies are dictated

1 L. v. Mises, *Theorie des Geldes*, Duncker und Humblot, Muenchen, 1924; *Die Gemeinwirtschaft*, Gustav Fischer, Jena 1922; *Die Ursachen der Wirtschaftskrise*, J. C. B. Mohr, Tuebingen, 1931.

by the trauma of the 1923 hyper-inflation, whereas the UK policies, with equal justification, are dictated by the trauma of the 1929–33 great depression. Yet this is not a real dichotomy. The great depression was also caused by wrong monetary policies and need never have happened in this terrible manner. Professor Friedman, in his monumental monetary history of the United States,[2] devotes a large part to the mistake of the Federal Reserve Board in reducing the money supply by 33% between 1929 – 1933, in response to the banking collapse. Had the Federal Reserve Board, in his opinion, met the internal drain by following Bagehot's advice of 1873, based on earlier Bank of England policies, by expanding and lending freely, this world catastrophe could have been largely avoided.

When this crisis reached Germany, a well-known German economist, H. Neisser, wrote an impassioned – though not heeded – plea: "Pay, pay, pay." Also in Germany the money supply was wrongly handled, with the result that over six million were unemployed.

The money supply in Germany was reduced by 25% between 1929 and 1931. Unemployment in 1929 had already risen to 13% (of union members – the base of calculation at that time): by 1931 it was 34%; and by 1932 around 45%. Prices during 1929/31 had fallen by 28%.

The UK story is well-known. The restrictive policies by the Bank of England were discussed in great detail before the Macmillan Committee[3] in 1931, e.g. Ernest Bevin, asking why bank rate was raised in 1929, with unemployment at over 10%. The addendum to the Macmillan Report, signed among others by Keynes, emphasized that the position abroad need not have prevented the Bank of England from furnishing additional credit: and the main Report states".

> that the recent worldwide *fall* in prices (27% in the UK between 1929 and 1931) is best described as a monetary phenomenon which has occurred as the result of the monetary system failing to solve successfully a problem of unprecedented difficulty and complexity.[4]

To sum up. Both traumata – hyper-inflation in 1922/23 in Germany and worldwide mass unemployment in the 1930s – had the same roots: wrong monetary policies. To quote J. S. Mill (from M. Friedman):

> There cannot be intrinsically a more insignificant thing in the economy of society than money. It is a machine for doing quickly and commodiously what would be done, though less quickly without it:

2 M. Friedman and A. Schwarz., *A Monetary History of the United States 1867 – 1960*, Princeton University Press, 1968.
3 *Committee in Finance & Industry 1931*, H.M.S.O. (Cmnd. 3897).
4 Ibid p. 93.

and, like many other kinds of machinery, it only exerts a distinct and independent influence of its own when it gets out of order.[5]

b. 1973

This year inaugurated the turn in inflationary trends since the mid-1960s. The boom was pierced by deliberate action of the BB in concert with the Government. The results seemed promising until the oil crisis at the end of October. But even this crisis was effectively met by the monetary authorities without an undue rise in the price level. It is convenient to look at 1973 in two stages.

i. Before the Oil Price Crisis.

The 1972 boom continued and was primarily fuelled by rising exports, particularly of investment goods, and by further speculative inflows of foreign money. Due to the BB obligation to support the dollar at the Smithsonian parity, this inflow reached its climax during the first quarter of 1973, which in turn increased the liquidity reserves of the banking system, creating a rapid expansion of credit to industry and consumer. This, despite restrictive policies by the BB and administrative controls over direct foreign capital flows into private business.

This monetary expansion further stimulated industrial production. Capacity utilisation reached nearly 100%, despite the continuing growth of the productive potential by around 4½% p.a.

Bottlenecks and labour shortages became more acute and wage rises (including wage drift) rose to around 10% – 12%. Consumer prices were up by 8% in the spring. The difficulty experienced by the BB in controlling the money supply helped industry to recoup higher wages and imported raw materials costs in higher final prices. Prices would have risen even higher had it not been for continuing improvement in labour productivity.

Production per hour of Employment
(1970 = 100)

1971	104.9
1972	112.0
1973	119.3
1974	123.3
1975	126.0 (est.)

Within the concerted action the dangers of increasing inflationary trends were clearly re-stated in February, 1973 (after having been discussed first in October 1972) and remedial anti-inflationary policies were then given the highest priority.

The restrictive stance of the BB was made effective by the EEC block floating which relieved the BB from supporting the dollar from mid-March. This squeezed the banks' free reserves to almost nil, and enabled the BB to control effectively the monetary base on which the banking system's lending ability rests. (For details – see chap. III). This was followed by several increases in BB re-discount rates and other restrictive measures vis-a-vis the banks, notwithstanding the consequential rise in market interest rates affecting past borrowers with escalation clauses – e.g. three months' money rising to 15% and bond yields to 10%. While the monetary base at the beginning of the year was still rising at an annual rate of 15%, by mid-summer this rise was cut to 5%, where it stayed until the turn of the year. A still more drastic cut was ruled out in favour of a more gradualist monetary approach towards reducing inflation, one which would avoid a sudden upsurge of unemployment and bankruptcies.

In February and May the Government introduced a number of fiscal measures in order to modify the expected boom. These took into account the known time lags in their effect. They were: a 10% surcharge on specified ranges of direct taxation, reductions in depreciation allowances, a tax on capital investment etc., a stabilization loan to be frozen at the BB, and several cuts or postponements in expenditure including building projects.

Summing up: In retrospect, the retreat from the Smithsonian rules provides at last – after six years – the missing link to the 1967 Stabilization and Growth Law by giving the BB the means of control over the money supply. The "Five Wise Men" in their 1973 report stated that it was for the first time that an . . . unsustainable boom was cut short so quickly.

The restrictive measures by BB and Government, coupled with the floating up of the DM by around 18% on average, had an immediate and dramatic effect in reducing inflationary expectations. All major components of domestic demand and output fell significantly below their medium trend, well before the oil crisis of October 1973. Only exports remained unaffected, and the current surplus during 1973 showed a significant increase mirroring the continuing inflation in other countries.

ii. The Oil Price Crisis.

The sharp rise in oil prices in the autumn of 1973 was a grave threat to the endeavours of a gradual reduction of the German inflation. Two dilemmas were faced: first between the demand deflating and cost increasing effects of the rise in oil prices and, second, between halting the depreciation of money and maintaining high employment. The latter had become apparent already since BB monetary policy had become effective.

The authorities' decisions were unequivocal; easements of the

[5] M. Friedman: *The Optimum Quantity of Money and other essays*, MacMillan 1969.

earlier fiscal restraints were authorised in December, but the BB continued its restrictive course, clearly indicating that the money supply would not be increased in order to accommodate all cost and wage increases. The BB thereby denied the economy the money to support a new inflationary spiral. This caused some rise in unemployment and a reducion in business profitability, though it dampened considerably the price push from the higher oil price.

FIGURE I

Principal West German economic data for 1973
with UK equivalent in brackets

Increase in GNP		5.1%	(5.2%)
Cost of living increase		6.9%	(9.5%)
Increase in Wage Costs per unit of output		7.6%	(8.8%)
Monetary base increase	1972	14.0%	
	1973	7.8%	
M3 increase	1972	14.1%	(27%)
	1973	9.0%	(28%)
Domestic Credit Expansion (% over previous year)	1973	13.2	(26.8)
	1974	8.6	(20.8)
	1975	8.0	(15.2)

c. 1974

In response to the oil price crisis the "Five Wise Men" submitted to the Government a special report in December 1973. On matters of economic policy they strongly advised the continuation of the BB restrictive money creation and not to over-compensate the inevitable production falls arising from less (and higher priced) oil by monetary expansions elsewhere. The experts expected for 1974 a sustainable real growth rate of the economy of at best 1%. Any attempt to raise this by monetary means would endanger the long-term stabilization programme. The main emphasis of monetary and fiscal policies should concentrate on structural adaptation to the new energy situation. Wage increases above 7% are considered attainable only at the cost of significantly rising unemployment and decreasing profitability of the corporate sector. Unfortunately the Unions did not heed these views of the experts and insisted, to the detriment of many workers, on much higher increases.

In retrospect, in the autumn of 1974 the "Five Wise Men" wrote:

> During 1974, the conflict between a smaller depreciation of money and high employment became sharper. The increase in the oil price made the burden of a gradual return to price stabilization more onerous, in particular through unsustainable wage agreements. The vigorous limitation of the growth of the monetary base by the BB however, curtailed the scope for increases in nominal national expenditure. Reduced capacity utilisation and rising unemployment clearly focus on the costs of inflation. In order to avoid a further rise in these costs to the country as a whole, monetary policy must pursue its course because only by these means can sustainable growth and employment be achieved in the future. The battle against inflation is nothing else but the attempt to safeguard employment for tomorrow.[6]

The Government broadly accepted these views.

In early 1974, the oil price rise again raised inflationary expectations, particularly of the Unions, whom it was impossible to convince that the BB would not countenance excessive wage increases by relaxing monetary policy. Wage agreements between 12% and 15% were made. As this raised real wages to unsustainable levels, unemployment, loss of profitability, lower investment, and a general deterioration of the business climate ensued. The committee of experts made an interesting calculation for 1974 to demonstrate the insignificant scope for real wage increases, viz:

Increase in real GDP per occupied person	+ 2.7%
less terms of trade effect	− 2.2%
less effect of employers higher social contributions	− 0.4%
Scope for real increase	+ 0.1%
Actual real wage increase	+ 4.0%

These trends reduced growth in net investment, raised the personal savings ratio to 14%, and caused sharp reductions in demand for inflation hedges, e.g. dwellings, cars and other durables. The BB was thus again able to reduce inflationary expectations, despite the higher costs of oil and other imported raw materials. Contrary to the anticipation by unions and some employers at the turn of 1973/74, of price rises much above 10%, in fact consumer prices rose by just under 7% during the year.

Only German exports were not affected; they continued to rise due to much higher inflation rates abroad. Most stimulated were investment goods, indicative of the lack of capacity in some of the western industrial countries. The surplus on current account as a proportion of GDP rose to over 4% against an average of the

6 Sachverstaendigenrat 1974.

previous 10 years of 2%, and was financed by German capital exports, extended trade credits and some liquidation by foreigners of their vast holdings of DMs in response to differential interest rates, e.g. three months' money in West Germany (autumn) 9¾%, Euro-Dollar 12%, and bond yields in West Germany 11% and UK 17%.

Little need be added to what has already been said about monetary policy during 1974. The BB continued with its steady and very moderate expansion of the monetary base, though in order to achieve this, the monetary instruments had to be used frequently, viz. changes in minimum reserves, lombard and rediscount quotas, interest rates, etc. The effect of this continuing restrictive money policy was visible in an increase of the monetary base by just over 6%, of M3 by 8%. Credits by the banking system to the inland corporate sector and households fell by one third against the previous year (January–September). The five experts' report in the late autumn of 1974 acknowledges that:

> the banks have now learned to walk at a tight monetary rein and that the BB is now in the position to enforce its chosen restrictive path with vigour.[7]

At the end of the year the BB announced a limit of 8% for the rise in the monetary base for 1975, implying the gradualness in reducing inflation over several years.

Fiscal policies were loosened in the light of the oil crisis. The main goal was to cushion the recession, yet to avoid conflict with the BB monetary restraints. It had already been mentioned that many fiscal curtailments of the Spring of 1973 were revoked after the oil crisis. Further to this, regional financial assistance was given to moderate the rise in unemployment, particularly in construction and housebuilding. The effect was a more than doubling of the public sector's deficit to approximately 2.9% of GDP. The five experts estimated that around 1.0% of this was anti-cyclical; the remainder however, was neutral (Konjunkturneutral) and consistent in the medium term with neither restraining nor expanding demand. The details are in chapter V.

Of major significance, though effective only in 1975, was a finance reform accepted by both Houses of Parliament in July 1974. It consisted mainly of increases in basic free allowances for income tax, the fixing of the highest marginal income tax rate at 56% and a simplification of the complicated structure of children's

7 *Sachrerstaendigenrat Gutachten 1974.*

allowances by graduated allowances, independent of income levels, starting with the first child. Later in the year additional public investments were approved and a subsidy for private investments with a time limit (July 1975) were introduced.

In retrospect it would appear that in 1974 there was a marked movement away from inflation determined industrial structures. Businesses which were only profitable under inflationary conditions of previous years either slimmed, looked for alternative investments or went bankrupt. There were also indications that export orientated firms began to realise that much higher inflation rates abroad stimulated their sales and they subsequently revised their investment strategies in anticipation of anti-inflationary policies eventually being applied in their respective export markets. Inflated motor manufacturing turned sharply down even before the oil crisis. Reduced inflationary expectations affected building of dwellings as an inflation hedge since 1973. Building permits dropped from 700,000 (dwelling units) early in 1973 to under 400,000 at the end of 1974.

FIGURE 2

Principal West German economic data for 1974

UK equivalent in brackets

Increase in GNP		0.6%	(–0.2%)
Cost of living increase		6.9%	(16.2%)
Increase in Wages costs per unit of output	1973	7.6%	(8.8%)
	1974	9.0%	(19.6%)
Monetary base increase	1973	7.8%	
	1974	6.2%	
M3 increase	1973	9.0%	(28%)
	1974	8.4%	(13%)
Domestic credit expansion	1974	8.6%	(20.8%)

d. 1975

BB and Government continued in their determination to reduce inflationary pressures still further. The creation of monetary base by the BB fell a little short – 7.9% – of the declared target of 8%. The Government did not hesitate to borrow heavily from the public in place of adding to the money supply. It would also appear that the public at large recognised that inflation is a monetary phenomenon, and that some temporary sacrifices in, for instance, employment and growth of real wages, had to be made in order to avoid the economic, distributive and social evils of further inflation.

Inflationary expectations therefore fell to their lowest level for many years, much lower for instance than during the previous recession of 1970/71. Most important, this enabled the social partners to agree on lower wage increases; for instance by the summer of 1975 basic wages were up by around 7½% and by the end of 1975 by a little under 7% (compared with the corresponding periods of 1974). This, though, did not materially affect company profits because the effects of stabilization policies, coupled with a sharp fall in exports, caused capacity utilisation to fall to 89% (94% in 1974 and 97% in 1973) – a level lower than any of the previous 10 years. Seasonally adjusted unemployment was a little over one million in the autumn. Consumer price rises were compressed to around 5.4% by December 1975 (6% over the year), next to Switzerland the lowest rise in Western Europe.

In 1975, GNP fell by 3½%, the drop in exports being a major contributing factor. Though in the short run this constituted a further "demand hole", the Sachverstaendigenrat considered this a way back to normalization, because in their view an export quota of a little under 30% of GDP is not structural, but (foreign) inflation determined. It is not sustainable both in the interests of West Germany and world trade.

By the third quarter of 1975 it would appear that the BR recession was bottoming out, and that some genuine, non-inflationary revival might be in sight, though unemployment would still continue above its "natural" level in response to the continuation of stabilization policies during 1976. But it is also not unlikely that in Germany as in other industrial countries for social, technological and institutional reasons the "natural rate of unemployment" has risen and that an early reduction of unemployment in the BR – below, say, 700,000 – would again tend to inflationary pressures. Though it must be emphasised that such a "natural" rate is not immutable, but can only be improved by structural and not by monetary means. This is a view strongly shared by the Sachverstaendigenrat, BB and Government.

The principal patterns of 1975 were: The BB increased the monetary base by just under 8%. When announcing the target rate of 8% at the end of 1974 its aim was to inform the social

partners of the monetary framework for 1975 implying that no excessive inflationary wages and price increases would be countenanced, and in agreement with the Government that no public sector deficit would be financed by simply raising the money supply. This average increase in monetary base did not proceed smoothly over the year, but was the result of many monetary factors. For instance during the first quarter of 1975, the BB created an increase in the monetary base by acquisition of foreign currency, rediscount rates, an increase in the lombard quotas and lower minimum reserve ratios. Yet the banks used part of this increased liquidity to repay debts to the BB, to increase their refinance quotas, and only partly to increase credits. During the summer the BB pursued some "open market" policies in Government bonds in order to influence interest rates, but this policy was given up after four months as it operated in clear conflict with the monetary stabilization programme. The BB also came to the conclusion that under the circumstances of the 1974/75 recession, interest rates would have to be reduced to unrealistic, if not negative, levels. This was to provide an incentive for industry to expand investment significantly, and for consumers to incur the burden of more hire purchase debt. Bank credits to business and consumers rose only by 3½% during the year. The banks had therefore to reduce the interest rates on time deposits to under 4% (from 8% on average in 1974) and unused money accumulated in current accounts (thus increasing M1 at a much higher rate than the monetary base rose). M2 on the other hand decreased – partly due to transfer to higher interest paying saving institutes which are governed by long-term interest rates rather than by the money market.

The new issue market for fixed interest paper shortened its time horizon to between eight and five and a half years. The average long-term (eight years) yield was around 8% after the BB had ceased to support the market. The shortening of the redemption period is probably due to less willingness of lenders and borrowers to commit themselves in view of uncertainties as to the course of inflation, interest rates, general business climate, etc., and in many instances loans have escalation clauses, adding to the caution of borrowers. There was, though, no difficulty in satisfying both the corporate and the public sectors' demands for non-inflationary credit.

The BB activities may be summarised in the words of the

Sachverstaendigenrat, in November 1975:

> The BB can be satisfied with the results of its policies in the third year of its consequent steering of the monetary base and in the first year (1975) of its self-imposed limit of monetary base expansion.

The medium term goal of reducing inflationary expectations and lowering retail price increases in 1975 to under 6% has been achieved (5.4% December, 1975, against December, 1974.)

The Government (including regions and local governments) did not hesitate to run up large deficits in order to prevent the stabilization crisis from degenerating into a self-accummulating "secondary deflation." (This term was coined by von Hayek in the 1930's)[8]. In addition to the fiscal measures announced in July 1974 (tax reform and children's allowances) and in December 1974 (additional investments by the Federal Government, subsidies of limited duration for private sector investments, etc.) some further outlays, primarily affecting building, infrastructures and introducing employment premiums, were agreed. These latter measures will, however, only become effective in 1976.

The public sector deficit (larger expenditure and nearly stagnant revenues) rose to over 2½ times its 1974 level, though by one billion less than anticipated in the autumn. The Sachverstaendigenrat again provided a calculation for 1975 indicating that the anti-cyclical push of the deficit amounted to 57% of the total. The financing of the deficit provided no difficulties due to the very high savings ratio of the personal sector and to the relatively low financing demands of the corporate sector (See chap. VI). Finance for the public sector was available at interest rates from around 3¼% to 8½% according to redemption periods. The December 1975 eight year loan was placed at 8%.

These monetary and fiscal policies set the framework for the trends during 1975 of the principal economic elements:

While basic wages were rising until the last quarter of 1974, by double figures, at the beginning of 1975, the unions reduced their demands very considerably, this time realising that monetary expansion would not be provided. Basic wage rate increases compared with corresponding periods in 1974 fell from 9% in the first quarter of 1975 to below 8% by the autumn. Some agreements went even lower – e.g. steel industry to 7%. The Sachverstaendigenrat expects basic wages at the year end to be up by only 6.8%. Also wage drift fell significantly. This market determined wage restraint is reflected by the very small increase in real wages. Repeating the calculation of 1974, the position is shown

[8] Unions, Inflation and Profits (in Studies in Philosophy, Politics and Economics) Routledge, London, 1967.

in the Sachverstaendigenrat report for 1975:

Increase in real GDP per occupied person	– 0.1%
Terms of trade effect	+ 1.6%
Less effect of employers' higher social contributions	– 0.7%
Scope for real increase	+ 0.8
Actual real wage increase	+ 0.9
Excess in 1975	+ 0.1
Excess in 1974	+ 4.0

This quite insignificant excess increase in real wages (+0.1%) may have contributed to a flattening of the seasonally adjusted unemployment increase and the reported vacancy decrease since the autumn 1975. Total unemployment still ranges above one million (seasonally adjusted) due to the general stabilization recession, the deliberate restrictive BB policies, the unsustainable rises in real wages during 1973 and 1974 and the fall in exports. To this must be added the falling off in growth of net investment since the early 1970s, with increasing emphasis on labour saving investment and structural industrial changes.

Despite wage restraint, profitability in industry continued to fall while lower capacity utilisation continued to raise wages costs per unit of output by 8% (9.0% in 1974) thus preventing any significant increase in profit margins. This happened despite lower raw material and interest costs. But it may well be that this fall in profitability is now halted: while total factor costs in *manufacturing* per unit of output rose during 1974 by 14%, the corresponding unit costs during 1975 rose by significantly lower rates, viz. during the last nine months by only little more than 5%. This trend in costs makes the Sachverstaendigenrat optimistic about an improvement in profitability once capacity utilisation returns to a more normal level during 1976. The first signs of this were visible in the last quarter of 1975.

The squeeze of profitability caused a slowing down in investment, the growth rate during 1975 in real terms being slightly negative. As mentioned above, the largest proportion of investment was directed towards labour saving and much less towards net expansion of industrial capacities. Yet despite this slowdown the ratio of investment to GDP was still 22%, though lower than during the 1960s and early 1970s, when it ranged around 26%.

Despite the increase in disposable income of households by

$10\frac{1}{2}\%$ – largely arising from the 1974 tax reform and higher children's allowances – consumer expenditure rose very little. This in turn raised the savings ratio to its highest ever level, viz. 17%. This can be interpreted in various ways; households wished to restore the real value of their liquid reserves, doubts about the future, but also greater confidence in a gradual slowing down of the depreciations of money. However this savings ratio dropped to 14% by the autumn, indicative of some prospects for economic recovery.

In December, 1975, the BB officially announced its target increase of the monetary base for 1976 at 8% on average. This is based on the assumption of a real growth rate of the economy of 2.5%, an increase in utilisation of the productive potential of 3.5% and an unavoidable inflation rate of around 4%. In its January 1976 monthly report, the BB elaborates on the target of 8% monetary base expansion:

> The BB sees indications that the recession may have started to subside since the late autumn of 1975 and that a growth rate (including higher capacity utilization and a 2% rise in productive potential) of around $4\frac{1}{2}\%$ during 1976 might materialize. Assuming a price rise of "only" 4%, the BB anticipates the requirement to finance a domestic expenditure increase by 9% on average. This in the view of the BB can be reconciled with the overall task of the further stabilisation of the value of money. The BB would prefer a faster rate of monetary stability, but is clearly conscious that this aim can only be achieved gradually. This gradualist approach is also necessary because the BB expects in conjunction with the expected business recovery during 1976, an increase in the velocity of money circulating (i.e. monetary base) which could accommodate an increase in domestic expenditure of, say, up to 10% without any strains. The BB insists that the 8% expansion in monetary base to be just the correct target for 1976. A greater expansion is ruled out because of the danger that this might be used to finance cost and price increases and not a real and sustainable growth of the economy. Also the BB appeals to the social partners to use this monetary framework for 1976, to expand production and employment and not to use it simply to raise costs and recover such cost increases in prices.

Principal West German economic data for 1975
(UK equivalent in brackets)

Increase in GNP	$-3\frac{1}{2}\%$	$(-2\frac{1}{2}\%)$
Cost of living increase	5.9%	(24%)
Increase in basic wage rates	7.0%	(25%)
Increase in wages costs per unit of output	8.0%	(28%)
Monetary base increase	7.9%	
M3 increase	7.3%	(10%)
Domestic credit expansion	8.0%	(15%)

e. 1976 – Prospects of Recovery?

Both the Economics Ministry and BB published at the end of January data indicating that the recession may have turned since the late autumn of 1975. Industrial demand – mainly at home, but also from abroad has tended to rise since August (seasonally adjusted). The rise in demand from abroad was largely concentrated on consumer goods and cars. The increase in home demand affected consumer goods, furniture, cars, etc. and also basic goods (e.g. chemicals, iron, steel). This suggests some upturn in the stock cycle. There are also reports of some increases in unfilled orders as businesses are not yet prepared to take on additional labour.

These demand trends are reflected in some rise in industrial production: seasonally adjusted industrial production in November 1975 was some 8% above the July trough and has thus regained one half of the decrease since the spring of 1974.

Though unemployment is still above one million, the latest increase was in line with the seasonal expectation. Short time working is lower than during the first half of 1975, but still high.

Monetarily this modest recovery since the autumn of 1975 is reflected in increased bank credits – short and medium term – to domestic customers, the private and corporate sectors exceeding considerably the borrowing by the public sector. But this expansion of credit was not in conflict with the BB's overall monetary base targets. Bond yields at the year end were between 8% – $8\frac{1}{2}\%$.

The cost of living index in December 1975 was 5.4% above the previous year. Producer prices of industrial goods are up by only 3%.

At the end of January the Federal Government published its statutory economic report for 1976. These are the significant points While warning not to confuse prognoses based on already known economic facts with prophecy and futurology, the report categorically states that the German economy is now in a state of recovery. The start of this recovery is dated as from the second half of 1975, when the first signs of rising domestic and foreign demand appeared. The Federal Government believes that its policies during 1975, flanked by the BB's modest increase in monetary base, have laid the foundations for a largely self propelled recovery during 1976. Intensity and duration, however, will depend to a considerable extent on recovery of world trade, reduction of inflation in other countries and, in Germany itself, on greater business profitability followed by higher new investment. The experts in the Ministry of Economics assume that industrial capacity may rise by about 2% and utilization of this increased capacity by between 2% and 3%. This, by affecting unit costs, should increase profitability of business quite significantly, – a reverse of trends of previous years. If this were not subsequently absorbed by unsustainable wage demands, the basis of some recovery in investment could be given. The economic report estimates that entrepreneurial incomes might rise by 12% to 14%, while wage and salary earnings, as opposed to wage rates, of 6½% to 7½% may be sustainable. (The corresponding increase in nominal gross wage and salary earnings in 1975 was only 4%, though in its purchasing power impact it was cushioned by tax reform and higher child allowances.)

In order to see this redistribution of incomes in favour of enterprises – predominantly then to be used for investment – in perspective, the report draws attention to the fact that since 1970 profits, rent and interest have risen by 45%, while wage and salary earnings rose by 73%. Included in profits, interest and rent are also incomes from pension funds, premium and share participation savings for employees, etc. – in other words not solely incomes for business enterprises proper.

In order to quantify and orientate the data, but not using it as predictions, the Federal Government would like to aim at:

1. an increase of GDP by 4% – 5% in real terms.
2. Investment (excluding building) to rise by around 5% in real terms.[1]
3. a reduction of unemployment seasonally adjusted to just around one million (1.1 million on average in 1975) falling to 890,000 seasonally adjusted towards the end of 1976.
4. a rise in the cost of living between 4½% – 5%.
5. a current account balance of 2½% of GDP (even if this implies some upwards floating of the Mark. This is NOT mentioned in the report, but may be implicit in the aim of keeping the current account balance to this level.)

A rise in GDP by 4% – 5% would bring it back to its 1973/74 levels, the highest in real terms so far.[2]

Though these are moderately encouraging data – based on current trends – the main employment problem will not be solved during 1976. For demographic reasons a surge of people will enter the labour market which in turn will require the provision of new work places through additional investment. This in turn will require the maintenance of profitability in a primarily market orientated economy. The economic report gives no quantification of the problem, but the IFO Institute estimates that between 1976 and 1980 productivity increases will enable only 400,000 people to find additional employment, while the demographic factors will cause the work force to rise by around 320,000. Only a small relief can be expected from the return of guest workers to their countries of origin. On average unemployment will not fall much below 700,000 over the period 1976 – 1980.

In order to enable the corporate sector to raise investment in the medium term, the Government is taking a number of steps consistent with the operation of the market.

1. Anticipating a Budget deficit for 1976, both Bund and Laender have already covered large parts of credit requirements to avoid competition with the private sectors later this year.
2. Public expenditure savings will as far as possible not be made at the expense of investment, but will concentrate on cut backs of current expenditure. The start of several public investment projects will be brought forward.
3. The Federal Government expects an early acceptance by Parliament of retrospective loss allowances which will be of particular liquidity benefits to small and medium sized businesses by increasing their cash flows during 1976.
4. By 1 January 1977, a significant reform of corporation tax should become operative. Though very complex in detail, this reform also aims through market forces to encourage investment.
5. Many measures will be introduced or existing ones improved during 1976 to aid mobility of labour, information as to vacancies or new labour market opportunities, increase and encourage substantially training or retraining facilities and to make sure that young people who have lost their jobs continue their job training. Such measures will also cover technical schools and other places for further job education. To put this into monetarist terms: all these measures are aiming at a reduction in the "natural rate of unemployment" in the medium term.

[1] This was exceeded by May 1976.
[2] This was achieved by May 1976.

CHAPTER III

German Monetary Policy since 1973

THIS chapter describes the change from traditional monetary policies of the BB – largely operating on the banking system's free liquid reserves and on the interest rate structures in the bond and money market – to the control and steadying of the growth rate of the quantity of monetary base available since around March 1973. Implicitly through this change the BB can now set targets for the growth of the money supply and it would appear that so far this has been achieved.

Some statistics by the BB show that between 1971 – the year of the Smithsonian agreement – and early 1973, the BB created through foreign currency inflows over 2½ times more monetary base than was required to satisfy the demand for home expansion of money.

Only the dispensation of the BB from intervening in the foreign exchange (mainly dollar) market, gave it the chance to adjust the level of the money aggregates.

To understand the methods used, some important technical details must be explained.

1. The banking system's liquidity (free reserves) is made up of all assets which the BB is willing to turn into central bank money, that is
   (a) Balances with the BB in excess of minimum reserve requirements.
   (b) Domestic money market paper saleable to the BB.
   (c) Money market investments abroad and foreign currency holdings (until March 1973)
   (d) Unused rediscount and lombard quotas with the BB.

2. The monetary instruments used by the BB include:
   (a) Open market operations.
   (b) Adjustment of discount and lending rates – as expressions of BB policy intents.
   (c) Rediscount facilities. Lombard credit quotas.
   (d) The minimum reserve requirements on the banking system's liabilities.
3. Discriminating measures were agreed with the Government against capital inflows from abroad until 1974 to curtail the banking system's rise in liquidity and direct inflows into the corporate sector.
4. Partly due to the large inflow of foreign money since the 1960's the banks gave up maintaining their customary minimum levels of free liquid reserves in stable proportion to their deposits. This enabled the banking system to extend credit and thus fuel inflation. The obligation of the BB until early 1973 to support the dollar made the monetary instruments difficult to make effective.
5. The joint EEC float since March 1973, gave the BB the chance of establishing the desired strict control over the money supply – this was because the banks' foreign balances and money market investments abroad lost their quality of potential central bank money. The banking system's free liquid reserves (which were already low prior to exchange rate floating) contracted to near zero following further restrictive measures by the BB. With this elimination in March/April 1973, of the banks' free reserves, the BB monetary policy was placed on a new footing: it was able to control the creation of central bank money directly instead of indirectly via the free liquid reserves and manipulation of interest rates.
6. The monetary base consists of currency plus minimum reserves on liabilities of the banks to which the Sachverstaendigenrat adds the excess reserves. So far the BB held the year on year expansion at around 7% to 8% with the declaration that the 1976 target will also be 8%. It is the intention of the BB to announce the growth targets well in advance to make the social partners aware of the direction of monetary policy. If U.S. experience can be a guide it may become possible for the BB to predetermine the money supply (M3) by fixing the growth path of the monetary base or to predict within reasonable limits of errors variations in the money supply arising from changes of the monetary base.[1]

[1] For an explanation of this process, see Federal Reserve Bank of St. Louis Review, September and October, 1975.

7. This emphasis since 1973 on control and moderation of the growth of the monetary base would seem to indicate that it is the agreed policy of the Government and the BB not to finance the Government's deficit by increasing the money supply. The temporary support which the BB gave to Government bonds during May/October 1975, threatened for a while this accepted aim, but these open market purchases to support the rate of interest were stopped. A member of the directorate of the BB in a speech reminded his audience of a pithy saying of some 25 years ago by a well-known German monetary economist, Albert Hahn: "Tight but cheap is incompatible".

The monetary achievements by the BB since 1973 are aptly summed up in the 1974 report by the Sachverstaendigenrat:

> By restricting the money supply in conformity with stabilization aims, the competitive market system regains its ability to function properly. The BB actions since 1973 transcend widely in significance the short term stabilising effects. They are of equal importance as the original social market order principles and the basic economic decisions taken after the war and ought to be regarded as lessons to other countries.

Some 40 years ago von Hayek wrote:

> It would be one of the worst things which would befall us if the general public should ever again cease to believe in the elementary proposition of the quantity theory.[1]

The new monetary stance of the BB is described in detail in the 1973 report of the Sachverstaendigenrat (pp 65 – 77) and in the 1974 report (pp 148 – 156 and p 200 in algebraic form). It is no doubt significant that the five experts were assisted in 1973 by Professor Brunner, for several years associated with the St. Louis Federal Reserve Bank Review, one of the outstanding monetary research centres and by Professor Machlup, one of the earliest pupils of L. von Mises in Vienna.

This is a very short summary of the 1973 report on the money supply:

Free liquidity reserves of near nil make it impossible for the banks to influence the "monetary base" of the Central Bank. If the banks are deprived of this influence they are unable to expand deposits and credits. If the BB intends to control the monetary base it must either deprive the banks of their free liquidity reserves or prevent through open market policies, orientated on the *quantity* of money and *not* on interest rates, an undesirable recourse by the banks to free reserves. The policy was for the

[1] F. von Hayek, *Prices and Production*, Routledge, London 1931;

monetary base to be enticed back to the BB in exchange of Open Market paper. Variations in monetary base and minimum reserve ratios indicate by how much (through the actions of the BB) the scope for monetary expansion has been changed. A stricter control of the monetary base requires a readaptation of the markets which deal in monetary base. If the market can no longer determine the quantity, but only the price (interest rate) at which the fixed monetary base is available, demand must reconcile itself that the shortage on the money market will lead to rising rates of interest and *vice versa*. If the quantity of monetary base is properly controlled then the BB cannot at the same time steer interest rates. Interest rates are henceforth the result of the predetermined supply of monetary base and the demand for monetary base coming from the money market.

The scheme of the determination of the money supply in West Germany in the terminology of the monthly statements of the BB is shown in fig. 3.

FIGURE 3

Scheme of determination of money volume in West Germany (Increases, decreases)

I. Bank credits to non-bank sectors
   i. Credit by BB
   ii. Credit by banks etc. (dependent on monetary base)
II. Net changes in foreign money assets
III. Money capital formation from inland sources at banks, etc. (incl. saving deposits, deposits over four years, etc.)
IV. Public sector deposits at BB
V. Other positions (net) arising from consolidated banking systems balance sheet.

VI. M2 = I + II – III – IV – V
of which
M1 = currency plus current account deposits
Quasi money = time deposits up to four years.
(M2 = M1 plus Quasi money)
M3 = M2 plus saving deposits of all kinds subject to legal time limits.

CHAPTER IV

Public Finance Policies

THE recession 1974 and 1975 coupled with the fiscal support programmes announced at the end of 1974 and during 1975 (see chap. II) increased the public sector's deficit (Federal Government, Regions, Local Authorities and Social Security Funds) from around 2.9% to 7.5% of GDP. Yet it was possible to accommodate this without deviating from the agreed moderate growth in money supply. The deficits of 1974/5 offset some of the falls in the private sectors demand and were financed by the personal sector from large savings, the correlate of these deficits.

In July, 1975, the official adviser to the Ministry of Finance submitted a report about the prospective Budget situation. It estimated the deficit (excluding Social Security Funds) for 1975 at about 60 Billion DM of which just one half was structural, viz. would persist even at full employment levels. In view of the recession, this report supports the deficit, but urged a gradual reduction in order to avoid "crowding out effects" when private investment begins to rise again probably as from 1976 – and also not to endanger the drop in inflationary expectations. The report principally advised reductions in expenditure and gave a long catalogue for economies, expenditure ceilings, greater efficiency per unit of outlay and even transfer of state activities to the private sectors.

In September 1975 the Federal Government announced expenditure cuts as from 1976 and some increases in taxation (as from 1977) which as far as the Bund is concerned is to reduce the deficit to one half in 1978 and to nearly one third by 1979. (Estimates for the Regions, etc. are not available).

A non-inflationary financing of the large deficit during 1975

could be achieved. This is because of the extremely high savings ratio of the personal sector which is the mirror image of the public sector deficit; this coupled with the small deficit of the business sector enabled the Government until May to place bonds at around 8%. The absence of a well-functioning capital market – despite 20 years of prosperity and high accumulation of money wealth – created some difficulties from mid-1975, for financing further Government expenditure. The BB intervened for a time in the Government bond market in order to prevent increases in interest rate resulting from the continuing high deficit. But the interventions stopped in October. Further finance was obtained by shortening the borrowing periods; during the first nine months of 1975 the credit institutions took up more than 50% of Government loans (medium and long term). They were enabled in this by the large increase in saving deposits from the non-banking sector. The rest was taken up by the private sector. It is now expected that with a continuing drop in inflation and a further fall of inflationary expectations during 1976 longer term finance will again become available. There are however two problems still to be faced: the increase in interest burden as a proportion of total Government expenditure and the redemption of some of the medium term debt over the next few years.

The proportion of interest payments of total expenditure rises from an average of $3\frac{1}{2}$% (1970–1973) to $4\frac{1}{2}$% in 1975. This represents some 22% of the total deficit. But since part of the increased interest burden is due to the recession-determined deficit, the Sachverstaendigenrat is not alarmed and expects in the longer run a reduction in the ratio of public sector interest payments to both public sector expenditure and GDP.

Redemptions of public sector debt are expected to average around 20 Billion DM p.a. over the next few years. In strictly financial terms this will pose no problem, but such monetization of debt could create strains to the stability in the growth of the money supply. But there is no reason to expect that the institutions in whose hands most of these debts are will not accept refunding terms and that the BB will be unable to counteract such monetization should it occur.

The Sachverstaendigenrat has introduced the concept of a "cycle neutral" public household and gives for each year an estimated breakdown of the total deficit into a "cycle neutral" deficit (the Sachverstaendigenrat terminology) and a countercyclical deficit.[4]

[4] The methodoligical and algebraic bases for the calculations can be found in detail in the *Sachverstaendigengutachten* for 1974, pp. 161f and 200f.

This breakdown is determined by the thought that the public sector is acting contracyclically if the actual household volume deviates from a "cycle neutral" volume. The public sector is considered as acting neutrally if its demands on the productive potential do not deviate from a "medium term normality". This is considered to be the case as long as the public sector makes such use of the productive potential to which the economy is adapted. Deviations from this ratio can still remain "cycle neutral" if the public sector by way of taxation reduces the private sector's demand on the productive potential. Figure 4 illustrates the breakdown of the deficit.

FIGURE 4

W. German Productive Potential and Contracycle Activity 1973-75

	1973 %	1974 %	1975 %
Cycle neutral public sector ratio of productive potential	29.84	29.70	28.65
Contra cyclical impulse	0.19	0.94	3.83
Actual public sector ratio of productive potential	30.03	30.64	32.48

This can also be expressed in a different way as follows:

	1973 Bill. DM	1974 Bill. DM	1975 Bill. DM
Actual GDP	928	996	1030 (est.)
Deficit of public sector (DM)	11	29	77
Deficit of public sector (%)	1.2%	2.9%	7.5%
of which contracyclical (DM)	2	10	44
of which contracyclical (%)	0.2%	1.0%	4.3%

Source: Adapted from data in the Sachverstaendigenrat report 1975 p. 105.

CHAPTER V

The Financing of the Corporate & Personal Sectors 1974 & 1975

a. Corporate Sector

THE fall in investment since 1973 is largely due to the fall in profitability. Cost increases could not be fully recovered in prices because of the restrictive policies of the BB and lower capacity utilization following falling demand – both at home and from abroad.

The only figures available on profitability for 1973 – 75 relate to profit to turnover.

	Profits as % of turnover
1973	2.41
1974	2.11
1975	1.85

Despite this fall in profitability, Gross Investment is still self-financed as to between ⅔ and ¾ out of undistributed profits and depreciation. The remaining finance, as is common in the BR, is provided by the banks. Placings of shares and fixed interest bonds by the Company sector are of minor importance. A breakdown of figures is now available for 1974.

Proportion of debt financing of Companies in 1974[1]

	%
Long and medium term	
Bank credit	25
Public authorities	16
Share issues	5
Bond issues	3
Short term	
Bank credit	22
Credits from abroad	16

1 Only the principal sources are shown and figures have been rounded.

Balance sheets in Germany are always weaker compared to those of UK companies. The ratio of "own means" (Eigenmittel) viz. in the case of public companies the ratio of equity plus reserves to balance sheet totals is rarely above 30%. During the recession (figures only available up to 1974) this ratio fell to below 25%, in some industries (e.g. construction) to around 10%. This would seem to explain the large increases in bankruptcies since 1974. This however, was not an unmitigated disaster as bankruptcies write off past debt, make recovery easier and correct misdirection of scarce resources through inflation.

b. The Personal Sector

Attention has already been drawn in previous chapters to the very high savings ratio of private households. It rose from around 14% during the early 1970s to about 17% during the first half of 1975. Several factors have contributed to this:

1. A wish to build up financial assets in relation to income to match the loss in the purchasing power of money.
2. A fall in "dissaving" mainly lower hire purchase debts and repayment of bank loans.
3. Less demand – mainly since mid-1974 – for the purchase of new dwellings, a sign of lower inflationary expectations in West Germany, and some saturation of demand arising from falling housing shortage.[2]
4. Some withdrawal of funds by private businessmen from their businesses into their personal savings.

This last factor is very volatile and it would appear that during the second half of 1975 such withdrawals were much reduced in anticipation of rising finance needs in 1976. This could explain the fall from 17% personal savings ratio to an estimated 14% during the second half of 1975.

c. Financial Balances

The BB publishes the sectoral balances which give a picture of the overall financing of the German economy.

Financial Balances (in Bill. DM)

	Households	*Companies*	*Public Sector*	*Overseas*
1975[3]	101	−33	−65	−5
1973	69	−78	14	−10

This – though somewhat mechanical comparison – shows clearly how the large deficit of the State is counterbalanced by a large surplus of the households. It also highlights the relatively low deficit of companies following the recession, and the continuing export of capital abroad (shown as minus sign). The

2 Institut fuer Staedtebau, Bericht 1976.
3 Excl. financial institutions (Banks, Insurances, etc.) Estimate 1975 by the Westdeutsche Landes Bank using BB methodology.

figures also summarize clearly the swings in the four sectors since 1973, when the recession started. Households moved into large surplus, companies reducing their deficits, and the Public Sector going into heavy deficit.

CHAPTER VI

The Totalitarian Enemy

THE protagonists of the social market economy never tire to point out that material welfare is not the ultima ratio of this system, but that it is a life embracing style beyond demand and supply and its final aim is a more humane and compassionate society. Professor Mueller-Armack borrows the simile of the magic triangle, the corners of which are now not economic aims, but personal freedom, economic security and social harmony. "It is an irenic order."[1] The improvement of the life environment is even more urgent than are material goods, essential though they are to achieve this better life for everybody. Significantly he borrows from the younger Marx the concept of alienation of work and he sees in the solution of this evil one of the most important tasks for the social market economy. A new industrial climate must be evolved he declares where man is the centre and work should again be a challenge and satisfaction, not a necessary evil. This improvement in the quality of life is the summons to the social market principles, which can lead to this goal and which totalitarian commands never will.

> We must proceed on a double path: humanising the environment, the firm, the incomes and wealth structure and yet give the individuals the chance to develop and apply their potentialities within the dynamics of technology, science and business.

But the totalitarian critics dismiss all this in a nineteenth century fashion as a trick of the capitalists to maintain their dominance.

They are intellectual forces advocating ideologies of abolishing the market, direct intervention against the market, or nationalization which, if followed, would lead anew to a command

[1] A. Mueller-Armack, *Genealogie der gozialen Marktwiktschaft*, Bern, 1974.

economy in Germany. The result would be loss of many personal liberties and adverse effects on living standards. After the war, Germany had at last liberated itself from a long tradition of interventionism which can be traced back to Imperial Germany and the concepts of the German historical school and the "Katheder Sozialisten" of the nineteenth century. The next generation may not remember this.

In 1971, the young socialists (Jusos) asked for a "synthesis of socialism, futurology and phantasy", which will generate a new civilisation, whatever this means. Individual freedom, according to the Jusos is more constrained by private property than liberty of thought by the infallibility dogma of the Pope! Also Galbraithian views of the power of the technostructure show their influence on the militants.

A recent book by the philosopher Harich asks for abolishing the world markets and substitution by a global system of just allocations. Money is also to be abolished and all allocative functions to be taken over by the computer. The allocations are to be decided by considerations of expediency on technical, ecological geological or ethnological grounds.[2] But who is to decide or rather to dictate? Another group of economists, one British, attacks the competitive system of the EEC and advises to replace it by state interventionism as the essential pre-requisite for sound economic planning. Saint Simon with a computer!

Yet is there a glimmer of hope? At the Mannheim SPD Conference in November 1975, two minority resolutions were defeated – largely based on Juso philosophies: strict control of direction and financing of private capital investment. The first minority resolution admits that such private investment control may also require direction of consumer demand. The second defeated resolution asks for nationalization of private banks and insurance companies, nationalization of large firms and rationing and central allocation of scarce imported raw materials. A suggestion of limiting the highest personal income to 60,000 DM (= approx. £11,000 p.a.) was not even discussed. To the Chairman's question "what criteria, apart from arbitrariness, should guide the State to direct private investment and to give permission to one firm to invest while denying it to another?", the Jusos had no answer and agreed that much more thought will have to be given to these problems.

[2] W. Harich, Kommunismus ohne Wachstum? 1976.

Postscript and Summing up

The Stage of Revival in the Spring of 1976

SINCE completing this paper at the end of January 1976, more economic indicators have become available confirming that revival in West Germany started slowly at the end of the summer 1975 and is now well under way.

GDP, which fell sharply during the first half of 1975, has increased by $3\frac{1}{2}\%$ during the second half of 1975 over the first half and is now level approximately (in real terms) with the first half of 1973, though still some $\frac{1}{2}\%$ below the peak reached during 1974. This recovery since late last summer would indicate that an annual growth of between 6% and $6\frac{1}{2}\%$ expected by several official bodies for 1976 is in sight. Industrial production, seasonally adjusted, has risen by 4% since December 1975 and is now some 12% above the trough of June/July 1975.

Industrial order levels including investment goods are continuing to rise. Capacity utilizations, depending on the different branches of industry, are nearing 90%. (Kiel institute enquiries).

Unemployment however is still above one million, seasonally adjusted. Short time has fallen dramatically and it is expected that it will soon be eliminated. Unemployment totals may fall below one million during the second half of 1976. The reduction of unemployment will largely depend on the speed of changes in industrial structures to be left primarily to market forces and not to Government intervention, and to the pending wage agreements once the unions can be persuaded that the real cost of labour is one of the strongest influences on the level of employment and capital investment. But the BB continues in its determination not to underwrite unsustainable wage increases through higher money supply and not to exceed the target rise in monetary base of 8% over the year on average.

Business liquidity is adequate for financing the revival. Interest rates are falling, e.g. the rate on saving deposits will be $3\frac{1}{2}\%$ as from April and overdraft rates at around 8%. The Federal Government was able to raise an 8 year bond in March with a yield of 7.59%. The latest (March 1976) currency upheaval made the BB spend during March some DM eight billion in support actions. It is therefore likely that the BB will syphon-off this undesirable liquidity from the banking system by raising the minimum reserve ratios. Otherwise the money supply target set in December 1975 might be endangered. By the end of March 1976 the external value of the DM has risen since January from an excess of 13.5% over the 1971 Smithsonian 14 nations average parity to around 20%. Investment is up by 12% (BB est. June).

Addendum May 1976:

BY the end of April, all major wage agreements had been completed, freely negotiated at economically sustainable levels. Only the printing trade took to industrial action in an endeavour to force above average wage rises. Overall industrial productivity is now rising at a rate of around 5% p.a. Unemployment continues to fall, though only slowly. The BB has raised the minimum reserve requirements on the banking system in order to neutralize the increased liquidity from the currency crises of March 1976. The budget deficit during 1976 is expected to be lower than anticipated in the finance plan 1975/1979 of Autumn 1975.

Summing Up

German economic policies have provided a framework for the BR to emerge from the deepest recession since the 1930s – largely generated by international events – within approximately two years of its onset in the summer of 1973. Despite recession the BR still has the highest standard of living of the EEC and, with Switzerland, of the whole of Europe. Geared to the high per head national product – the BR provides the best social security benefits and in particular for very large sections of the population old age is no longer a financial nightmare. Inflation, the cause of much unrest and instability in other countries, is slowing down from relatively low levels if compared with the UK and may fall to 4% by the end of 1976.

But more important than economic indicators: despite one million unemployed (compared with the UK statistics, the German figures somewhat overstate the numbers) the social fabric has remained intact, no unbridgeable political polarisation and social peace maintained, well illustrated by the quite insignificant number of days lost by strikes throughout this period. If there is a shadow in this picture it is the not too compassionate treatment of the guestworkers and some pockets of poverty in poor rural areas and big towns which have so far escaped the wide net of the BR social economic system.

What greater vindication and tribute to the few men, who not presentient of the future impact of their thinking on Germany, began to lay the intellectual foundations of a socially orientated liberal economy some 50 years ago against the planning bias of Weimar and the dictatorship of the Third Reich.

Working in relative isolation, they succeeded in synthesizing the best of German sociological research into economic orders and systems represented by once-famous names in Germany: Spiethoff, Loewe, Sombart and Max Weber – with the analytical economics of the Austrian marginal utility school. This school in turn provided them with a bridge to the English classics of the eighteenth and mid-nineteenth centuries and their tenets of the superiority of a competitive free order over the policies of mercantilism, the command economy of these days. Superior both in efficiency, aiming to provide human happiness, and in social morality. The latter was by no means sacrificed by the English classics to the Protestant ethics that only the successful pursuit of self-interest can lead to Eternal Salvation.

The social morality for the classics implying amongst many values – sympathy and compassion (Adam Smith) for the disadvantaged, education and health provision out of public funds (Adam Smith), the goal of the "friends of humanity" to see real wages rise well over the *young* Malthus subsistence levels (e.g. Ricardo in his *Principles*), Jeremy Bentham even advocating public works to relieve unemployment, and continuous social reforms (e.g. J. S. Mill)[1]. From Hume to J. S. Mill, a span of nearly 150 years, a strong emphasis by all important writers (e.g. Senior, McCulloch etc.) on the rule of law to ensure that liberal individualism did not conflict with the public good and "the state erecting and maintaining certain public works and institutions, which cannot be expected that any individual or small number of individuals should erect or maintain." (Adam Smith, *The Wealth of Nations*, 1776 Book V).

This indicates a strong continuity of thought – though in the course of time changing and enlarging its content – in the tradition

1 For extensive details see Prof. L. Robbins, *The Theory of Economic Policy in English Classical Political Economy*, Macmillan 1952. Also F A. Hayek, *The Constitution of Liberty*, Routledge 1960, particularly chapters 11 and 15.

of true English economic liberalism in spontaneous co-operation between the State and the individual which the German social market economy has so successfully emulated for nearly 30 years.

This despite the unavoidably adverse effects of world inflation, particularly on unemployment, from which the BR could not insulate itself. But the BB's strict control since 1973 over the monetary base and the gradual reduction of the government deficit until 1979 augur well for the further success of the BR social market economy. Yet to squeeze out the effects of several years of inflation takes time and, unfortunately, implies a level of unemployment above its natural rate for a temporary period.