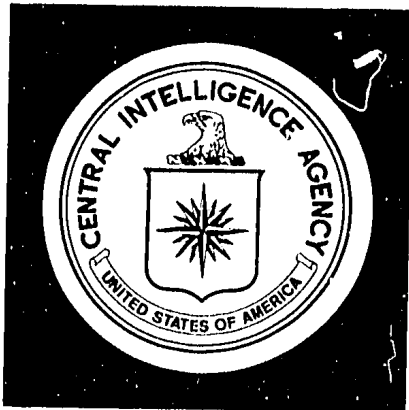


25X1

Approved For Release 2006/04/19 : CIA-RDP85T00875R001700040025-9

Approved For Release 2006/04/19 : CIA-RDP85T00875R001700040025-9

Confidential



DIRECTORATE OF
INTELLIGENCE

Intelligence Memorandum

The West German Economy: Early Recovery A Mixed Blessing

Confidential

ER IM 72-142
October 1972

Copy No.

25X1

Approved For Release 2006/04/19 : CIA-RDP85T00875R001700040025-9

Approved For Release 2006/04/19 : CIA-RDP85T00875R001700040025-9

CONFIDENTIAL

**CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
October 1972**

INTELLIGENCE MEMORANDUM

**THE WEST GERMAN ECONOMY:
EARLY RECOVERY A MIXED BLESSING**

Summary

1. After stagnating in 1971, West Germany's economy is again on an upswing. Continuing buoyant private consumption, some easing of restrictive monetary policies, and a high level of construction made possible by an unpredictably mild winter all combined to prevent an expected drastic decline in business activity and a correspondingly large rise in unemployment in the early months of this year. These factors, together with an improved economic climate following the December Smithsonian monetary agreement, as well as gradually improving profit margins in the wake of moderating wage demands, have now largely dispelled the gloom in the business community.

2. Some soft spots still remain, but leading indicators suggest the economy will expand at a steady, though not spectacular, pace through the year's end. Industry's order books are slowly filling, profit margins are improving, investment is picking up, and unemployment - which failed to rise as much as feared during the slowdown - has leveled off. Lingering uncertainties on the international monetary scene, heightened anew by last June's sterling float, could still affect recovery. But the introduction of controls over capital inflows has strengthened Bonn's monetary defenses, and in any case, the increasing strength of domestic demand reduces the economy's vulnerability to foreign influences.

3. Inflation is the economy's Achilles' heel. Inflationary pressures have again accelerated, aggravated in part by Bonn's inability to halt the rapid rise in public spending, and the August cost of living index was up a near-record 5.7% over a year ago. Given the almost pathological fear of

Note: This memorandum was prepared by the Office of Economic Research and coordinated within the Directorate of Intelligence.

CONFIDENTIAL

CONFIDENTIAL

inflation, especially among the older generation of Germans whose savings were wiped out twice in a lifetime by runaway prices, the cost of living index probably will be one of the key political barometers during the next few months.

Discussion

Background

4. The 1971 slowdown, precipitated by Bonn's deliberate anti-inflationary policies, was aggravated by growing uncertainties in the international monetary system. With domestic investment and foreign demand flagging, gross national product (GNP) in constant prices declined steadily from its first quarter high (see Figure 1). For the full year, the real growth rate was 2.7%, down from 5.5% in 1970 and 8.0% in 1969. Industrial production increased even more slowly - less than 2%, compared with 6% and 13% in the two previous years. While production cutbacks led to some layoffs, employers more typically sought to maintain their work forces by reducing the workweek. Unemployment (seasonally adjusted) rose gradually throughout last year, reaching about 230,000 in the last quarter - up from 150,000 in 1970 - but was still less than 1% of the total labor force.

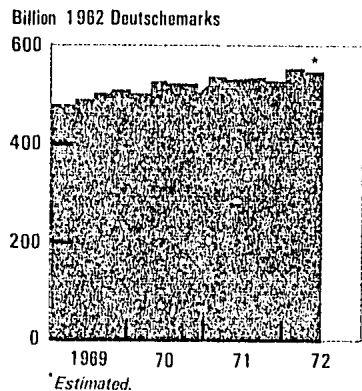
5. Moderated wage increases, reduced overtime, and lowered prices of imported raw materials and semi-finished goods gradually eased industry's cost pressures during the year. Reflecting these developments, as well as weakening domestic and foreign demand, industrial producer prices, which had risen sharply since 1968, began to level off by mid-1971. With consumer spending remaining strong, however, retail prices continued to climb, and the cost of living index rose a record 5.9% by the end of the year.

6. Concerned primarily about the intolerably high rate of inflation, Bonn maintained its restrictive policies in an effort to break the wage-price spiral. At the same time, Karl Schiller, then Minister for Economics and Finance, prepared a contingency, pump-priming budget to be activated if a recession threatened to develop. A recession would be politically just as damaging to the Social Democratic/Free Democratic coalition as excessive inflation. Monetary policy also remained tight, as the Bundesbank pressed hard to reduce the banking liquidity, which had been swollen by massive capital inflows before the May Deutschemark float. Amid gathering signs of the slowdown, however, the Bundesbank eased its policies slightly toward the year's end.

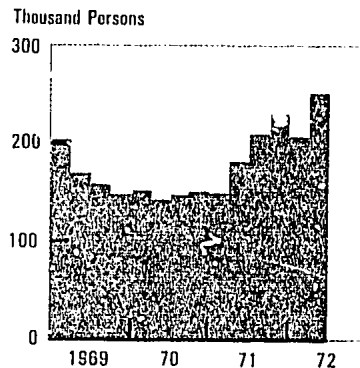
Figure 1

West Germany: Selected Economic Indicators (Seasonally Adjusted)

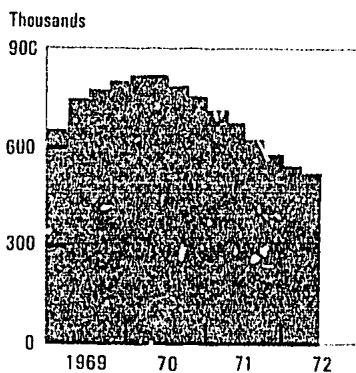
GNP, Quarterly Figures at Annual Rates



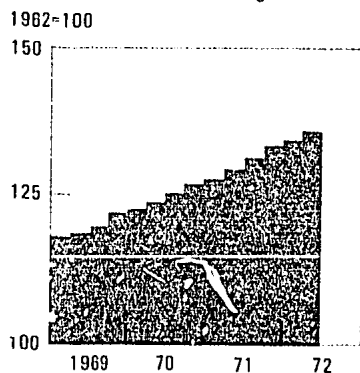
Unemployment



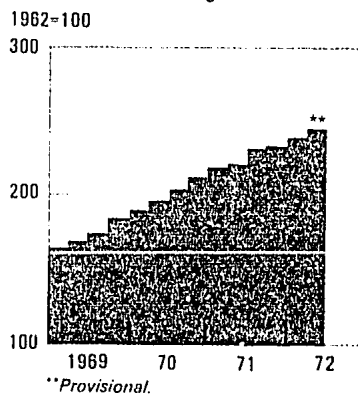
Vacancies



Cost of Living



Wages



514511 10 72

CONFIDENTIAL

7. Business confidence, already flagging in the face of declining orders, shrinking profit margins, and the prospect of increased corporate taxes, was badly shaken by the international monetary crisis precipitated by the float

25X6



Pessimism deepened as businessmen found their concern echoed in dire commentary by bankers and in forecasts of highly respected economic research institutes which uniformly predicted an accelerated downturn in the first half of 1972.

8. These fears proved premature. Unusually favorable weather in late 1971 permitted an unseasonably high level of construction which prevented a drastic decline in business activity and a large increase in unemployment. Building investment increased an unusually high 15% during the winter months. At the same time, private consumption rose about 4%, largely as a result of rising demand for automobiles and other consumer durables. These factors, together with the reduction in the de facto appreciation of the Deutschemark and the return to fixed parities following the December Smithsonian monetary agreement, as well as gradually improving profit margins in the wake of moderating wage demands, brought about an upturn in business expectations.*

The Economy Picks Up

9. In the first three months of 1972, real GNP grew 3.7% over the preceding quarter. To be sure, this good showing was influenced by such exogenous factors as the favorable winter weather and the catch-up in production in the important metal working industries that had been hard hit by strikes in late 1971. Nevertheless, the continued rise in GNP through the first half of 1972 (2.2% over the corresponding 1971 period) and the renewed increase in orders booked by industry suggest that the improvement is more basic and that recovery is under way.

10. Businessmen apparently believe that prospects are looking up. The rise in domestic orders for machinery and equipment provides tangible evidence of an improved investment climate. Growing inventories and rising orders for raw materials and semi-finished goods also indicate improved business confidence. Contrary to earlier fears, investment in machinery and equipment during the first half of 1972 appears to have reached the level

* By mid-December 1971, the float had produced a de facto revaluation of the Deutschemark in excess of 12%. As a result of the Smithsonian currency realignment, the revaluation was reduced to an average 6%-7% relative to all other currencies.

of a year ago and well above the second half of 1971. Because strike-delayed orders and the reduction of the investment tax early this year undoubtedly contributed to this favorable development, however, it is probably too early to speak of a sharp upward trend in investment activity.

11. Foreign orders have increased significantly, quieting widespread fears that a revalued Deutschemark would price German goods out of foreign markets. Early in the year, the normal order flow probably was increased by orders previously delayed as importers hoped that the currency realignment would reduce the extraordinarily high Deutschemark appreciation during the float. More recently, cyclical factors have become more important as the rate of economic growth in most of West Germany's principal trading partners has accelerated, increasing their aggregate import demand.

The Labor Market Becomes Firmer

12. The cyclical rise in unemployment – substantially smaller than during the 1966-67 recession – has virtually halted. While overall employment has not as yet begun to increase, the number of workers on reduced work shifts has declined drastically. On a seasonally adjusted basis, unemployment in July 1972 was about 300,000, or 1.1% of the labor force, and reported job vacancies numbered more than 500,000. At the same time, the foreign labor force exceeded 2.3 million, up 7% from the year before.

13. Union wage demands, which were scaled down significantly last fall under the threat of an impending recession and increasing unemployment, have not moderated further this year, but neither have they increased. Gross hourly wages (seasonally adjusted) during the first half of 1972 were up 10% over the corresponding period in 1971. The comparable increase for 1971 over 1970 was more than 14%.

Inflationary Pressures Remain Strong

14. Declining cost pressures have not slowed the price rise, because businessmen are apparently intent on widening profit margins that had shrunk substantially during the earlier period of rapidly rising costs. The seasonally adjusted rise in the cost of living index did decline briefly to a 4% annual rate in the first quarter of this year. Since then, however, it has accelerated, and, this August, living costs were 5.7% higher than a year ago. Wholesale prices, more immediately affected by import competition (especially the reduction in the Deutschemark price of imports following last December's revaluation), have remained steadier.

The Foreign Sector

15. Despite two Deutschemark revaluations during the past three years, West Germany's foreign economic position remains Europe's strongest, and its foreign exchange reserves the world's largest. Export growth slowed substantially in the second half of 1971 (as was to be expected in view of the decline in foreign orders during the prolonged period of uncertainty regarding the international monetary system in 1971). In the first half of 1972, however, exports grew 7.4%, and the trade surplus (f.o.b./c.i.f.) reached 8.4 billion Deutschemarks (\$2.6 billion) up 22% from the corresponding 1971 period (see Figure 2). Reflecting the impact of the Deutschemark float and subsequent revaluation, the trade surplus in terms of US dollars increased a whopping 37%. Nevertheless, with rapidly rising deficits in services (largely German tourist expenditures abroad) and transfer payments (foreign workers' remittances), the current account was approximately in balance. It had shown a small surplus (\$160 million) during the first half of 1971.

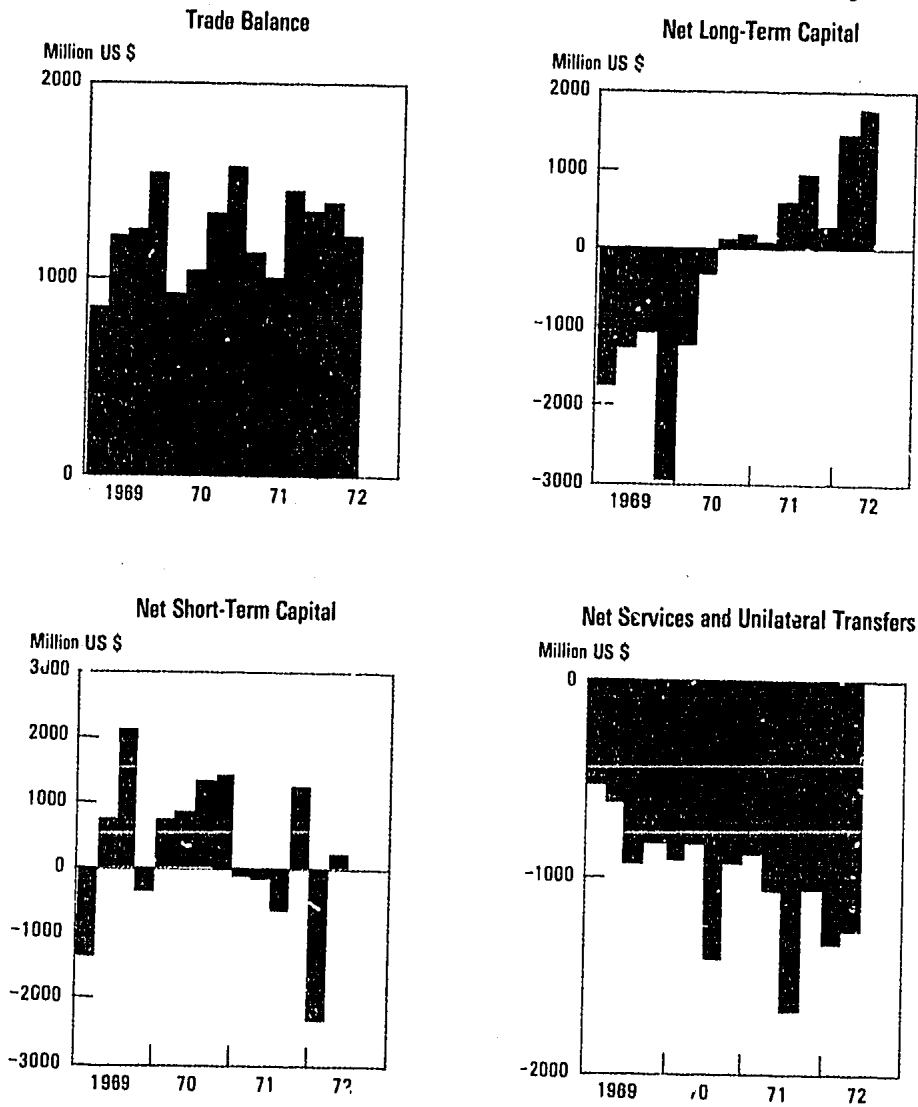
16. Reflecting the impact of the Cash Deposit Law (*Bardepotgesetz*), activated this spring to discourage the inflow of short-term funds generated by the interest rate differential between the West German and foreign (now primarily Eurodollar) money markets, the short-term capital account showed a new outflow of \$2.1 billion in the first half of the year. But this was more than offset by a net inflow of \$3.3 billion in long-term capital. West German and foreign money managers simply switched into bonds to circumvent the Cash Deposit legislation. Limited controls over the sale of fixed interest rate securities to foreigners were introduced in late June (over the strong opposition of Schiller, then Minister for Economics and Finance) to plug this gap in West Germany's monetary defenses. The Bundesbank's gold and foreign exchange reserves, swollen by extensive purchases of US dollars in defense of the Smithsonian monetary agreement during the mini-crisis set off by the June float of the British pound, stood at \$25.5 billion on 31 August 1972, up from \$17 billion at the end of last year.

The Near-Term Outlook

17. Most observers believe that economic expansion will pick up during the coming months but will remain within the bounds of available production capacity and labor reserves. Business has upped its investment plans, and that means rising expenditures for machinery, equipment, and inventories. With a firming labor market promising added income and greater job security, polls show that consumers expect to increase their purchases — especially of durables, including cars, refrigerators, and color television receivers. Finally, the accelerating cyclical upswing in the United States and other major West German trading partners promises brisker foreign demand for German products.

Figure 2

West Germany: Major Components of the Balance of Payments



514512 10-72

Note: Data converted into US dollars at the 17 December 1971 exchange rates.

CONFIDENTIAL

18. The prospect for containing inflation is far less promising. There is little if any hope of reducing the cost of living increase to the government-targeted 3% annual rate in the foreseeable future. The upturn came unexpectedly early, upsetting Schiller's anti-inflationary game plan. Instead of falling to a 3% annual rate, a low rate by world standards, the cost of living was rising at more than 5% - in marked contrast to the 1% increase that prevailed in the fall of 1967 when the economy began to pull out of its last recession. Still, there are at least two vital differences between then and now that could affect the government's chances for inflation control. In 1967, the Deutschmark was seriously undervalued, and excessive foreign demand - as well as massive inflows of speculative funds anticipating revaluation - significantly contributed to inflationary pressures. Since then, the Deutschmark has been revalued on the average about 20% relative to the currencies of the country's principal trading partners. The resulting sharp rise in the foreign exchange cost of German products should in time serve as a brake on foreign demand. Moreover, strengthened control over the domestic money supply has enhanced the Bundesbank's ability to fight inflation through monetary policy.

25X6

21. Government expenditures have in fact been rising rapidly -- as they did under previous administrations - but the rise probably is more

CONFIDENTIAL

CONFIDENTIAL

the effect than the cause of inflation. In the attempt to dampen inflationary pressures, proposed budgetary expenditures have repeatedly been scaled down, forcing the postponement of politically important social infrastructure projects. In fact, persistent budgetary strictures have prevented Brandt from implementing many of the socio-economic reforms that provided the basis for his 1969 platform. With non-discretionary and defense spending accounting for the major share of federal outlays, the government has very little scope for employing expenditure policy as an anti-inflationary instrument. Nor has the revenue side of the budget offered a more viable alternative. Schiller recommended a temporary and refundable income tax surcharge in early 1970 to cool off private demand, but even that faced strong opposition in the Bundestag. It was enacted only after much delay - and by then it was too late to do much good. Given the downtrend in the economy during most of last year, further tax increases would have entailed the politically unacceptable risk of precipitating a recession. While there is now general agreement that some tax increase will become unavoidable, if only to reduce the rising federal deficit, the upcoming elections rule out any action along this line pending the formation of a new government.

25X6

And Some Important Non-Issues

23. Foreign economic and monetary policy are not likely to produce significant partisan fireworks. Brandt and Barzel are widely agreed in their views on West Germany's role in the European Community (EC) and on West German-US economic relations. Both men support further progress toward EC monetary union, provided parallel progress is ensured toward coordinating or harmonizing economic policies generally. Both back the EC's Common Agricultural Policy and, under strong pressure from the well organized and highly vocal German farm bloc, both defend high support prices for key agricultural products. At the same time, they strongly advocate an outward-looking orientation for the EC and favor the institutionalization of an EC dialogue with the United States to resolve outstanding economic issues.

24.

25X1

25X1

On the question of international monetary reform, both men share the EC view that Special Drawing Rights (SDRs) should increasingly supplant the dollar as the principal reserve medium, and both can be expected to resist French demands for a substantial increase in the price of gold and an enhanced role for gold in the international monetary system. Keenly aware of the continued importance of US support, both men would work hard to mediate US-EC differences.