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Can West Germany weather the oil shock?

by Alice Roth

Earlier this year, it appeared that, except for Britain, the major countries of Western Europe would scarcely be affected by the doubling of oil prices which occurred in 1979. West Germany, in particular, recorded spectacular growth rates in the first quarter of 1980, spurred by a 16 percent jump in real fixed capital formation. West German inflation was then running at about six percent, which although high by West German standards compared favorably with the 18 percent U.S. inflation rate at that time. By the second quarter, however, a rapid decline in industrial production and orders had become evident, in West Germany and throughout Europe.

Will this recession prove a mere temporary setback, or is West Germany, like the United States, doomed to a prolonged period of negative or slow growth combined with higher inflation? The answer to this question is critical, especially when one considers that the West German economy is a major prop for France and Italy, as well as Belgium, the Netherlands, and the other smaller European economies.

To answer this question, it is first necessary to understand what lies behind West Germany's relatively better performance when compared with the United States. Although it is widely recognized that rising exports have been the driving force behind West German expansion during the 1970s, the full significance of that fact has unfortunately been missed by the U.S. economics profession. Exports are key in any advanced economy because they permit industrialists, particularly capital goods producers, to produce on a scale which would never have been possible had they been confined to domestic markets. The apparent "overproduction" that arises due to the inability of the domestic market to absorb new capital goods and new technologies rapidly enough is overcome. At the same time, the absorptive capacity of the domestic market is itself broadened, because producers have the financial wherewithal to "depreciate," or write off, old capital investments more quickly, bringing on-line new plant and equipment incorporating the latest technological advances. Such high-technology investments enable industrialists to boost labor productivity, resulting in lower unit labor costs and reduced prices.

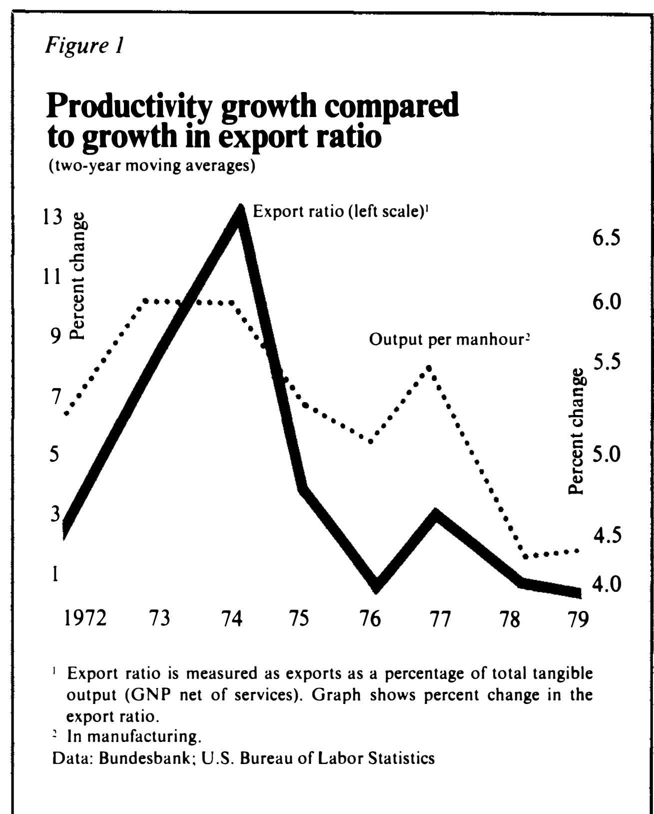
Thus, the answer to our first question, "Can West Germany recover?" depends on the answer to a second: "Can West Germany expand its exports rapidly enough to maintain the high rates of capital formation and productivity growth necessary if it is to offset the higher costs of imported oil?" Unfortunately, the statistical evidence shows that West Germany's ability to do so has seriously eroded since the first oil price runup of 1973-74.

One key indicator, exports as a percentage of total tangible output, continued to grow after 1974, but at an increasingly slower rate. (See figure 1.) Between 1970 and 1974, West German exports grew from 25.5 percent of tangible output to 33.7 percent. In 1979, this ratio, at

Figure 1

Productivity growth compared to growth in export ratio

(two-year moving averages)



[1] Export ratio is measured as exports as a percentage of total tangible output (GNP net of services). Graph shows percent change in the export ratio.
[2] In manufacturing.
Data: Bundesbank; U.S. Bureau of Labor Statistics

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35.4 percent, was not much of an improvement over the early 1970s. Similarly, labor productivity growth rates (measured as output per manhour in manufacturing), although still impressive, slowed from an annual rate of 6.1 percent in 1973-74 to 4.3 percent in 1978-79.

The reason for the slowdown in the growth rate of the export ratio is not difficult to identify. West Germany's EC trading partners, who together account for 50 percent of the country's exports, were less able to absorb the impact of the oil price hikes than was West Germany itself. More important, the most promising new market for West German capital goods—the developing sector—was largely shut off as higher oil costs forced these countries to accumulate huge debts and the International Monetary Fund stepped in to enforce austerity.

Meanwhile, the growth of fixed capital formation in West Germany, particularly in manufacturing, failed to regain the rates of the late 1960s and was apparently insufficient to wipe out the accumulated obsolescence of four years of under-investment in the mid-1970s. (See Figure II.) According to a study prepared by a West Berlin-based institute (DIW), capacity obsolescence in the West German business sector surged from an estimated DM 25.7 billion in 1970 to DM 46.3 billion in 1976 (in 1970 prices). This increase was aggravated by the fact that part of the capital stock was no longer profitable to operate under the high energy cost regimen. Higher rates of capital formation in the late 1970s succeeded in knocking down this obsolescence figure to DM 36.6 billion by 1970, still DM 10.1 billion higher than the 1970 level.

Another result of the mid-1970s oil price hike was that it changed the character of capital investment in West Germany. Whereas the investment boom of the late 1960s aimed at expanding manufacturers' capacity so as to take advantage of growing world markets, capital spending in the recent period has emphasized modernization, including the installation of more energy-efficient equipment and the application of microelectronic technologies. During 1979, for example, real investment in electronic data processing machines increased by about 20 percent, compared with an overall growth in machinery and equipment spending of 10 percent. However, industrialists have been for the most part merely replacing obsolescent plant and equipment and not making major net additions to capital stock. (See figure II.)

In short, Otto Wolf von Amerongen, the chairman of West Germany's leading industry confederation, was absolutely correct when he warned in a speech on Sept. 9 that without both higher rates of capital formation and faster write-offs of technologically obsolescent capital stock, West Germany would not be able to "ride out the rough seas of the 1980s."

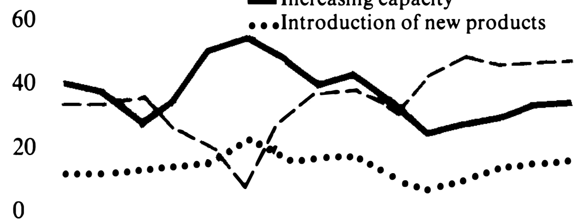
The situation is by no means hopeless, since West Germany's government, unlike that of the United States, is well aware of the necessity of opening up new export markets and is placing strong emphasis on the promotion of trade ties with both the East Bloc and Arab oil-producing nations.

East-West deals similar to the DM 20 billion Ruhrgas project to develop Siberian natural gas could prove a windfall for West Germany, providing that détente is maintained. Western European governments must also move ahead on the long-delayed second phase of the European Monetary System—creation of a gold-backed European Monetary Fund capable of supplanting the

Reasons given by manufacturers for investment

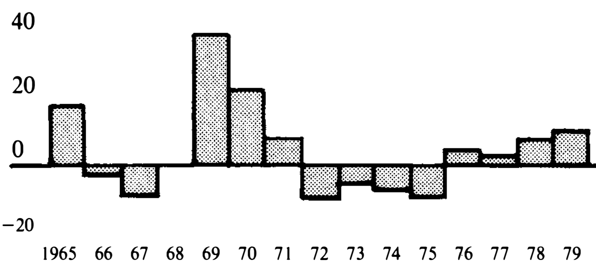
Percentage of firms[1] reporting as investment motives:

Figure 2



Real change of gross fixed capital formation

in manufacturing over previous year[2]



[1] Weighted with turnover
[2] 1977 and 1978 preliminary; 1979 IFO estimate.
Source: IFO

The first graph shows the results of a survey conducted by a West German economic institute, in which manufacturing firms were asked to give their reasons for new capital investment. In 1979, nearly 50 percent of those surveyed reported that the purpose of new investment was to introduce new technologies, while only 30 percent reported that their aim was for increased capacity. West German industrialists appear to have focused in recent years on increasing productive efficiency, but, due to stagnating world markets, have held back from additions to capacity. The bar diagram below shows that the real growth rate in investment in manufacturing peaked in 1968-69 and has never regained this level.

IMF-World Bank and funding high-technology industrial projects in the non-oil-producing Third World.

A report issued by the executive board of Dresdner Bank last week at the World Energy Conference in Munich could point the way to a solution of the energy crisis. Dresdner calls on the Western world to spend $10 trillion on energy equipment over the next twenty years. About one-half of the monies should be invested in nuclear energy and electrical power grids, the report states, with the rest going into further development of oil, coal, and natural gas.

Behind Europe's current recession

Industrial production fell at an annual rate of five percent during the second quarter in Western Europe, according to estimates published by Morgan Guaranty in its monthly newsletter *World Financial Markets.* The causes of this recession, which caught many analysts by surprise, are essentially two-fold: first, higher prices for gasoline and heating fuel. Second, Western European governments have been forced to respond to Volcker's high interest-rate policy by maintaining unusually restrictive monetary and fiscal policies in their own countries.

Real personal after-tax income has been declining in most Western European countries for the last six to nine months. In West Germany, for example, it is estimated that households must spend nearly 10 percent of their total budgets on energy this year, as compared with 6 percent in 1979.

The drop in real incomes has had devastating consequences for the European consumer durables sector. Opel, the West German subsidiary of General Motors, expects that its sales in Western Europe will drop by more than 14 percent this year. New car registrations in West Germany for all automakers are expected to decline by 8.0 to 8.5 percent this year.

In Italy, the Fiat management has been threatening to permanently lay off 24,000 employees by the end of 1981, as part of a plan to reduce auto output by 20 percent. It is rumored that Fiat may be trying to provoke the Italian government into taking over Fiat's automaking division, freeing the company to develop other "more profitable" lines of business. In France, Peugeot is contemplating whether to abandon its plan for building a new auto components plant in Lorraine.

Moulinex, the leading French appliance manufacturer, is reportedly planning to lay off half its workforcce, totaling 10,700 persons, in October. Indesit, Italy's second largest producer of electrical appliances and an employer of 13,000 persons, is reported to be on the verge of bankruptcy.

This slump in the consumer goods sector has slashed demand for steel. EC Commissioner Etienne Davignon has been attempting to persuade European steel manufacturers to agree to a 13 percent cut in production during the fourth quarter. West Germany and Italy have so far refused to go along, raising the specter of a European price war, which could further undercut steelmakers' profitability.

Aggravating the recession is the fact that high interest rates in the U.S. and Britain have forced the Bundesbank to maintain historically high interest rates, so as to avoid an outflow of capital. West Germany's monetary policy today contrasts sharply with that of 1975, when the central bank permitted interest rates to drop sharply to help along the recovery. West Germany's restrictive policy has prevented other members of the European Monetary System from slashing their rates for fear of unleashing a wave of speculation against their currencies. In West Germany, prime corporate borrowers must now pay interest rates of 11.5 percent, compared with 14.4 percent in France and 20 percent in Italy.

The Bundesbank's apparent tight-fistedness is intended to offset the country's ballooning current account deficit resulting from increased oil import payments. In July, West Germany reported a trade surplus of only DM 100 million and a current account deficit of DM 5.2 billion, its largest deficit in 20 years. For 1980 as a whole, West Germany's deficit could run DM 30 billion.

The European economic situation could deteriorate further if, as appears highly likely, Volcker continues to jack up rates in the U.S. Leading New York bank economists, such as Morgan's Rimmer de Vries, are predicting a major crisis in the EMS by the end of the year if the reduction in European rates is delayed.

A major question mark is whether European industrialists will begin to scale back capital spending plans. A recent report by the IFO, a Munich-based economic institute, claims that West Germany's capital spending boom, still going strong in the first half of 1980, has now peaked and that capital spending in manufacturing will barely match inflation during 1981. French Premier Barre announced last week that beginning with the new fiscal year in October, French companies will be eligible for investment tax credits amounting to FF 5 billion a year, probably not enough to keep French investment growing. Barre has otherwise maintained a fairly strict lid on government spending and has adopted the slogan "Severity Works." ■