West Germany's Economic Policy: What Direction?

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The Revival of the Locomotive Strategy

Recently there has been a revival of the "locomotive strategy," which was first applied in 1977–78. At that time, politicians and many economists argued that a lack of demand could stall economic recovery, that unemployment would remain on an extremely high level, and that serious external imbalances would persist (Gebert and Scheide 1980). As a result, "strong" countries—those whose economies had a low rate of inflation and a current account surplus—were pushed to adopt more expansionary monetary and fiscal policies. The philosophy behind the strategy was that the strong countries, namely, West Germany and Japan, had a special responsibility for the world economy. Proponents of the locomotive strategy argued that because these economies were in a healthy position they could alleviate the problems of "weak" countries, which otherwise would be forced either to adopt unduly restrictive policies or to take recourse to protectionism.

When the upswing in the economy gained momentum in 1979, the locomotive strategy was followed by the "convoy approach," which directed strong economies to guide weak ones toward more growth and less unemployment. On the way, however, the convoy steered into an inflationary storm and the whole fleet fell apart.

Especially in the strong countries, inflation rates increased markedly and the current account moved into deficit. In West Germany, for example, inflation accelerated from about 1 percent in the second half of 1978 to almost 8 percent in the first half of 1981, and the current account moved from a surplus of about 1.5 percent of GDP

Cato Journal, Vol. 6, No. 3 (Winter 1987).

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(18 billion DM) in 1978 to a deficit of 2 percent of GDP (28 billion DM) in 1980. After that experience, the locomotive strategy seemed to lose ground.

During the early 1980s, there was a broad international agreement that inflation rates had to be brought down and that employment and growth had to be strengthened, but not by stimulating demand. Instead, improvement of the basic conditions for growth and employment was emphasized. Supply-side policy was the new recipe. There was no consensus among governments, however, on what kind of measures had to be taken. In fact, very different policies were pursued under the name of supply-side policy.

In the United States, a restrictive monetary policy aimed at reducing inflation was combined with a significant (by European standards) tax cut and a marked expansion of public expenditures. Some markets were deregulated (trucking, airlines, banking, and energy) in order to increase competition. Another important feature that distinguished the United States from European economies was the flexibility of the labor market in terms of labor cost and manpower (OECD 1985, p. 104).

In West Germany, policymakers implemented a tight monetary and fiscal policy; the reduction of inflation and of the external and internal (budget) deficit were considered to be the preconditions for a sound economic recovery. In order to narrow the public sector deficit, taxes were increased and expenditure growth was kept below the growth rate of nominal GNP. Some cases of income transfers to private households were cut slightly, but most of these steps were later reversed. The increase in labor costs moderated only marginally.

In France, the socialist government that came into office in 1981 did quite the opposite. Monetary targets were moved upward and public expenditures were expanded strongly. In particular, welfare payments were extended and minimum wage earners were granted above-average wage increases. It was hoped that the resulting demand push would ignite an even faster growth of investment, spearheaded by the expansion of the nationalized industries, and that this would ultimately result in less unemployment, less inflation (because of the supply effect of investments), and a self-financing of the expenditure program.

Thus, after having tried to establish a close coordination of macroeconomic policies under the locomotive strategy during the late 1970s, there was a period of policy competition among major industrialized countries during the early 1980s. To some extent, the authorities used the scope for autonomous policies that is given under a system of flexible exchange rates (Vaubel 1980). But soon it became clear that autonomy did not mean that the country could insulate itself from economic influences from abroad. Freedom had its price.

The French experiment failed rather soon, because the exchange rate arrangements within the European Monetary System (EMS) had reduced the scope for autonomous action. Because the Mitterand government preferred to defend the franc rather than to stick to its program of demand expansion and social reforms, it reversed its policy stance in 1983 and adopted a strategy more or less in line with West Germany's.

The West German government achieved its goals. The rate of inflation declined, the budget deficit was reduced substantially, and the current account moved into surplus in 1982. In spite of these improvements in the underlying conditions of economic growth, however, the increase of GNP since 1983 was noticeably weaker than in previous upswing periods and unemployment continued to rise until mid 1985.[1]

The U.S. approach proved to be more effective, particularly in terms of growth and employment. From 1983 to 1985, real GNP rose at an average annual rate of 4.2 percent compared to only 2.5 percent in West Germany and 1.2 percent in France. Even more remarkable was the expansion of employment, which contrasted sharply to the poor employment performance in Western Europe. The growth differential between the United States and European economies was hardly sufficient to explain the difference. It is probable, however, that greater flexibility in the U.S. labor market and economic deregulation contributed greatly to the pronounced improvement in employment. The rate of inflation, which had declined from 13.6 percent in 1980 to 3.2 percent in 1983, remained moderate despite the strong upswing in 1983–84. No progress was made, however, with respect to the federal budget deficit. It had not been reduced by the upswing; on the contrary, it widened significantly, as did the current account deficit.

Notwithstanding the twin deficit, foreign investors were attracted during the first half of the 1980s by the new strength of the U.S. economy. The result was a strong appreciation of the dollar. For companies, it would have been quite normal (and necessary) to imitate a more successful competitor in order to catch up to and defend market shares. The European governments, however, considered the flight from their currencies into the dollar as an undue interference in domestic policies. In order to prevent higher import prices from

[1]From 1983 to 1985, the average annual growth rate of GNP was 2.5 percent compared to 4 percent after the recession of 1974–75 and 6.5 percent after the 1967 recession.

fueling domestic inflation, they felt forced to raise interest rates. High interest rates, however, were seen as the major impediment to the upswing; therefore, they called for a reduction of the U.S. budget deficit instead of improving growth conditions by lowering marginal tax rates and deregulating markets in their own economies.

The different strategies predictably led to different outcomes and to strong exchange rate reactions. From 1980 to the spring of 1985, the dollar appreciated markedly vis-à-vis the European and the Japanese currencies. U.S. authorities showed little concern about the strong dollar and the high deficits as long as the economy advanced rapidly. But during 1984, economic growth weakened and the Reagan administration began to worry about the loss of competitiveness due to the strong dollar. In 1985, when contractionary effects were anticipated from the implementation of Gramm-Rudman-Hollings, Secretary of the Treasury Baker and others rediscovered the urgent need of international cooperation in the field of demand management in order to harmonize the results of economic policy in industrial countries. As in 1977–78, countries with a low rate of inflation and a current account surplus, such as West Germany and Japan, were singled out for more expansion.

Recent U.S. policy recommendations differ little from the advice Robert Solomon offered the 1978 Bonn Summit; namely, that by adopting the locomotive strategy

> the risks of exacerbating inflation would be minimal. But real benefits would result, primarily for the industrial countries themselves in the form of higher income and lower unemployment. The threat of creeping protectionism would be blunted, investment would be encouraged, and a better pattern of balance-of-payments positions would emerge. In particular, the very large surpluses of Germany and Japan would be reduced.

Likewise, in 1986, Anthony Solomon argued:

> Now that exchange rates are on a more reasonable course and oil prices are declining, there is every likelihood the inflation rate in Germany will be negative in 1986. Clearly, that ought to offer immense opportunity for the German authorities to provide stimulus to lower the current-account surplus, to lower unemployment and to contribute to a better balance in the world economy without threatening any outbreak of inflation.

Are German authorities sacrificing a good deal of employment and output that could be mobilized by "feeding some marks to its economy and advancing its tax cuts"? Or do low growth and the employment problem in West Germany and elsewhere in Europe stem from other sources so that they cannot be solved by just expanding demand?

To answer these questions it is useful to look at recent economic developments in West Germany.

Economic Growth in West Germany Since 1983

Overall output in West Germany has gradually recovered since the trough of economic activity at the end of 1982. In the final quarter of 1986, real GNP was about 12 percent higher than in 1982; on a per capita basis the increase is in the order of 13 percent. The recovery was initiated by a strong acceleration of monetary growth and by some temporary fiscal incentives to investment. These measures led to an upswing of domestic expenditures in 1983 (Table 1). Monetary expansion was slowed markedly in the second half of 1983, however, when the D-Mark again started to depreciate against the dollar and higher import prices threatened to push up the rate of inflation. Therefore, domestic expenditures more or less stagnated in 1984. From the fourth quarter of 1983 until the first quarter of 1985 the increase in real GNP was almost exclusively due to the increase in net exports.

After the deceleration of monetary expansion had come to an end in 1984, the domestic economy began to recover again. During 1985 and early 1986, it received strong impulses: Monetary policy became increasingly expansionary since mid 1985; at the beginning of 1986, income taxes were cut by about 11.5 billion DM (0.6 percent of GNP);

TABLE 1

CONTRIBUTION OF DOMESTIC EXPENDITURES AND NET EXPORTS TO GNP GROWTH IN WEST GERMANY, 1982–86

	GNP (Fourth quarter over fourth quarter, percentage change)	Domestic Expenditure (Change in percent of GNP)	Net Exports (Change in percent of GNP)
1982/81	−1.4	−1.2	−0.2
1983/82	3.5	4.8	−1.3
1984/83	2.8	0.3	2.5
1985/84	2.2	2.8	−0.7
1986/85	2.5	4.2	−1.6

SOURCE: Deutsche Bundesbank.

and the drop in oil prices provided a considerable real income gain for the economy.

In spite of these stimulating influences, growth slowed during the final quarter of 1985, and there was even a decline of total output at the beginning of 1986. This was partly due to the lag in the effect of monetary policy and to extremely severe winter weather. In addition, companies and consumers reacted cautiously to the strong appreciation of the D-Mark and the drop in oil prices. Because companies expected a further decline of import prices, production activity was cut back for a while in order to run down stocks of finished goods that had been produced at higher input costs. Consumers hesitated to increase spending because they were uncertain whether or not the increase in purchasing power resulting from the oil price decline would last for a longer period.

During the second quarter of 1986, however, demand and production began to pick up again. In particular, investment in machinery and equipment increased strongly. As capacity utilization in the overall economy was nearly as high as in 1979–80, the peak of the previous business cycle, and as profit expectations had risen noticeably, capital widening became more important. The share of such investment, however, is still comparatively low. Private consumption also rose appreciably. Compared to the same period in 1985, total real expenditures on consumption and investment were some 4 percent higher during the second half of 1986. Although the upswing is already more than four years old, the economy is now close to price stability. In the summer of 1986, the index of consumer prices was even somewhat lower than 12 months earlier because of the sharp decline in import prices (−20 percent on a year-over-year basis).

The labor market has improved somewhat. Since reaching a low point in 1984, employment has increased by some 600,000 and short-time work has declined by half a million. The number of unemployed remained high because the labor supply was growing due to demographic reasons and a higher participation rate. In the course of 1986, however, unemployment went down slightly.

What are the lessons to be drawn from the experience of the years 1983 to 1986? First, despite the pronounced reduction of the public sector deficit and the rate of inflation, total output increased by about 3 percent per annum. The most important force behind this was the increase in domestic expenditures.

Second, there is no evidence that economic growth in West Germany relied excessively on exports (Shilling 1985; de Vries 1986). Although exports grew faster than total output, the upswing got only temporary support from exports. For the period as a whole, the increase in imports was much higher.

Third, the expansionary policies at the beginning of the upswing had only a short-run effect. Because the increase of M1 of more than 12 percent was inconsistent with keeping the inflation rate down, domestic demand began to stagnate again as soon as the policy stimulus had to be withdrawn. Thus, the attempt to increase the growth of overall output in the medium run by temporary stimulatory measures failed.

Fourth, domestic economic activity recovered quickly when monetary and fiscal policy were switched (measured in demand terms) from a restrictive to a more or less neutral policy stance.

Finally, the labor market reacted to the recovery, but not enough to reduce unemployment significantly. The elasticity of employment with respect to capacity utilization was about as high as it was during the late 1970s. The fact that the capacity utilization is already very high suggests that the increase of employment is not hampered by a lack of demand. Instead, the impediments are to be sought in the area of labor costs and insufficient incentives to invest in new capacities.

Short-Term Growth Prospects of West Germany

In 1987, domestic demand is likely to be stimulated by strong impulses and monetary policy will remain expansionary. The target set for the increase in central bank money is a growth of between 3 and 6 percent. In view of the decline of inflation, the target is quite generous; at any rate, it is too high to keep the rate of inflation at zero. In fact, central bank money has even increased at a current rate on an annual basis of some 8 percent. Narrow money, M1, which has been a reliable leading indicator for the direction of economic activity, expanded at an annual rate of more than 10 percent in 1986.

Considering the strong pressure on the West German central bank to lower interest rates, it seems unlikely that the Bundesbank will take action to restrain the growth of the money supply in order to meet its target. As in 1977–78, it will probably tolerate the high growth of the money supply in order to avoid a further appreciation of the D-Mark. Therefore, domestic demand will presumably continue to expand vigorously during most of 1987. The drastic decline in oil prices combined with the appreciation of the D-Mark will give additional impulses to domestic demand, because part of the real income gain becomes effective only during 1987. In 1987, expenditures on consumption and investment will probably increase by 4.5 percent. While export growth will remain moderate because of the real appreciation of the D-Mark by about 10 percent since the spring of 1985, imports will surge due to buoyant domestic demand.

Since the beginning of 1985, the trade account in constant prices has already deteriorated noticeably (Table 2). This trend is likely to continue; in real terms, the surplus in the foreign balance will decline from 5 percent of GNP in 1985 to about 2 percent in 1987. Real GNP is expected to increase by about 3 percent in 1987.

In 1986, real incomes increased in West Germany; there was a considerable rise of production and employment, and prices remained stable. In 1987, however, inflation is likely to rise again when domestic cost pressures are no longer dampened by falling import prices.

No Demand Constraints to Growth

On the whole, there is no need for further stimulation of demand in the West German economy. On the contrary, as the economy is already operating close to its capacity limits in many sectors, the expected acceleration of demand is likely to result in some overheating of the economy.

Given the present policy stance and the business outlook, why do some economists insist that German authorities should turn to reflation? One possible answer is that the views on the importance of economic targets differ and that there are different views on the appropriate instruments to achieve those targets. Another answer is that the recommendations are based on an inappropriate analysis of the West German economy. An inspection of the critical comments on West German economic policy suggests that both answers seem to play a role.

TABLE 2

WEST GERMANY'S TRADE PERFORMANCE, 1985I–1986IV

		Ratio of Export Values to Import Values	Ratio of Export Volume to Import Volume
1985	I	100	100
	II	102.8	101.7
	III	104.1	99.3
	IV	104.8	99.7
1986	I	109.1	97.3
	II	111.4	94.4
	III	116.4	96.3
	IV	114.3	94.3

SOURCE: Deutsche Bundesbank.

Scope for a more expansionary policy is seen because the rate of inflation has dropped to a very low level. Price level stability, however, has not been achieved by a stability of domestic costs and prices; instead, it has resulted exclusively from the decline in import prices by more than 20 percent. Assuming a strengthening of economic activity in industrial countries, it seems unlikely that oil prices will fall again in 1987; and given the strong increase in the money supply, the D-Mark will probably appreciate only moderately vis-à-vis the dollar over the next year. Therefore, in 1987 price stability will weaken as domestic demand grows stronger. The rate of inflation will then be determined once again by the rate of increase of domestic prices, which will probably be in the order of at least 2.5 percent due to relatively high wage increases and strong demand. The increase of nominal wages in 1986 by more than 4 percent was higher than in 1985, although the inflation rate was noticeably lower than in 1985 and workers benefited from the tax cut. For the 1987 bargaining round, higher inflation rates as well as higher profits give reason to expect wage increases that will be even above those agreed on in 1986.[2] As there will be no improvement in the terms of trade comparable to that in 1986 and as demand is still buoyant, higher wage costs will be translated into higher prices. Therefore, already at the end of 1987 consumer prices will probably increase by more than 3 percent. At present, the growth rate of the money supply is significantly higher than would be consistent with such a rate of inflation. Therefore, a further upturn of inflation rates beyond 1987 is very likely if monetary expansion remains strong.

An increase of the rate of inflation is sometimes regarded as the price that a country has to pay for a higher rate of economic growth. But experience has shown, especially the failure of the locomotive approach during the late 1970s, that there is no positive relationship between inflation and real growth. Economic policy cannot buy more growth (and jobs) with more inflation. Nevertheless, this philosophy is still underlying many comments. By accepting a higher rate of inflation, the United States has not achieved a significantly higher rate of long-run growth than West Germany. Presumably, the favorable performance of U.S. employment during the 1970s and 1980s did not result from tolerating more inflation; rather, it resulted from the greater flexibility in U.S. labor markets. Those who exert pressure on West German policymakers to reflate in order to decrease unemployment seriously ignore an important fact, namely, that the introduction of labor market rigidities and the reduction of wage differ-

[2]In the metal industry wages will rise by 13 percent from 1987 to 1989.

entials between regions, branches, and qualifications contributed greatly to the increase of the West German unemployment rate during the last decade (Gundlach 1986; Donges 1985).

Increasing Labor Market Rigidities

An inspection of labor market data since the 1960s shows that there has been a significant deterioration. Until 1973, unemployment rates hovered around 1 percent. During the 1974-75 recession, unemployment rates (number of unemployed as a percentage of the dependent labor force) rose to about 4.5 percent. During the following recovery, from 1976 to 1980, the unemployment rate only declined to 3.5 percent. During the recession of the early 1980s, the rate jumped to about 9 percent. Given present labor market rigidities, unemployment will hardly drop below 8 percent until 1987. In 1985, about one-third of all jobless persons registered at the labor exchange had been unemployed for a year or more, compared to 5 to 10 percent of long-term unemployed during the early 1970s.

What accounts for the high level and the stickiness of the unemployment rate? One reason is that labor costs are comparatively high in West Germany, too high to offer sufficient employment opportunities for less qualified workers or in weak branches or in regions with structural problems. One reason for this is that the wage contracts between employers' associations and unions are based on expected average increases of productivity, profits, and prices. Until the late 1960s, contractual wages were significantly lower than effective wages. During the 1970s, however, the wage drift narrowed and almost disappeared. Because contractual wages are minimum wages for the whole industry, companies with below average productivity gains found it more and more difficult to cope with increased wage costs. German workers have to enjoy not only quite a high income, but they are also entitled to six weeks' annual leave plus 10 to 15 extra holidays (depending on the state they live in), unlimited sick leave, and a work week that is approaching 37 hours. Actual retirement age is well below 60 years. All this adds up to a considerable wage bill. Because early retirement, extensive health care, and relatively generous unemployment benefits are expensive, social security contributions have been raised noticeably. As a share of GNP, they have increased from less than 12 percent during the late 1960s to 17.5 percent during the mid 1980s. Half of these contributions have to be paid by employers; the other half is deducted from the worker's gross income. The latter part has been translated into higher wage increases, because trade unions succeeded in defending net wages. Employers managed to reduce labor costs by cutting employment, however, particularly during recessions and by turning to labor-saving production methods. Nevertheless, total labor costs rose faster than the productivity of labor. Operational profits, that is, profits from productions (not from financial investment), have declined massively over the last 15 years (Dicke and Trapp 1984, 1985). In spite of the recent recovery, these profits are still quite low compared to the early 1970s and only marginally higher than the real rate of return on financial assets.

The high unemployment rate is also affected by workers having less mobility and more wage inflexibility, because the incentives not to work have been increased over the last 10 years. This policy has produced at least three significant developments. First, the marginal tax rate (including social security contributions) is presently at about 60 percent for an average income earner (Boss et al. 1986). Therefore, instead of working overtime many workers prefer to work at home or in the shadow (underground) economy, which is estimated to be 10 percent of the total output of the official economy.

Second, the amount of welfare payments that a family is entitled to when there is no earned income comes close to the net income of an average wage earner (Boss 1986). A family of four without income, for example, can collect welfare payments that add up to at least 78 percent of the average net income of a family of four with one income earner. Because of the high level of welfare payments, additional wage increases for low income groups were agreed upon in 1986 in the public service and in the metal industry.

Finally, the German parliament, the Bundestag, has passed a number of laws since 1970 designed to enhance job safety. Consequently, the costs of layoffs are now four times higher than in 1972 (Soltwedel 1984). In practice, these regulations have made the labor market more rigid and were an important reason for the reluctance of companies to increase employment during upswing periods.

These examples illustrate that the unemployment problem in West Germany is deeply rooted; it is structural in character and not solely attributable to deficient aggregate demand. Therefore, unemployment cannot be overcome by additional demand, as was already evident in 1979–80.

The Current Account Balance: A Growth Perspective

The advocates of the locomotive strategy view not only unemployment but also the surplus in the current account as indicators of insufficient domestic demand and mentioned them as a reason for reflation. As to the 1986 increase of the current account surplus to some $35 billion (3.5 percent of GNP), it has to be seen that this is not related to the development of real magnitudes but is only the result of a strong improvement of the terms of trade, particularly of the redistribution of the OPEC surplus. Because the West German economy will not experience a similar terms-of-trade improvement in 1987 (more likely there will be a slight deterioration) and because imports will expand rapidly, the surplus in the current account for the year as a whole will probably decrease by 25 percent in 1987 and even more during the course of the year.

Given the high rate of unemployment and insufficient growth of potential output in West Germany, any export of domestic savings, which is the counterpart to the surplus in the current account, may appear to be undesirable from a domestic point of view. In this respect, the adequate remedy would not be to reflate the economy but to make investment more attractive by lowering taxes, deregulating protected sectors, and allowing for more flexibility in the labor market. As a result of such policies on the micro level, the West German current account could move into deficit, which then should be accepted. It would indicate that the West German economy has become more attractive to investors worldwide.

If the U.S. deficit in the current account decreases because the Gramm-Rudman-Hollings act is applied, however, there is no need to stimulate demand in West Germany. When world savings are unchanged and the U.S. current account deficit falls, interest rates could go down further. This would ease the burden for debtor countries and stimulate investment there and in Germany and Japan. On the other hand, if the deficit of the U.S. current account remains high because investment opportunities there are considered to be better than elsewhere, this should give an incentive to other countries to improve investment profitability by cutting taxes, removing subsidies, and deregulating markets.

Conclusion

It has been stressed that there is no need for more coordination of macroeconomic policies, particularly for a reflationary policy in Germany. But this should be interpreted neither as a rejection of policy coordination in general nor as a general defense of what West German economic policy has done over the last several years. As to coordination, there are many areas where concerted action is urgent, but these do not concern macroeconomic policies; they concern issues such as the world-wide abolishment of regulations and barriers to trade and the elimination of restrictions on capital flows. In particular, the protectionist trade policy pursued on both sides of the Atlantic has to be changed.

As to West German economic policy, the government must do a great deal to live up to the market-oriented policy it promised to implement after the 1983 election. Taxes have to be cut—and by more than is envisaged for 1988 and 1990—in order to ease the tax burden of average income earners and to lower the top rate and the progressivity of the tax schedule. Subsidies amounting to almost 7 percent of GNP must be reduced. A Kiel Institute study shows that a combination of lowering subsidies to 3.5 percent of GNP and of cutting taxes by the same amount over a period of five years could create one million additional jobs (Gerken et al. 1985). Furthermore, the welfare system has to be trimmed and deregulation has to be intensified. Such steps are urgent and would help to revitalize the economy. A further stimulation of demand, however, will lead to the old stop-and-go pattern of economic policy and, therefore, is not to be recommended.

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