

# Lessons from Germany's Economic Recovery

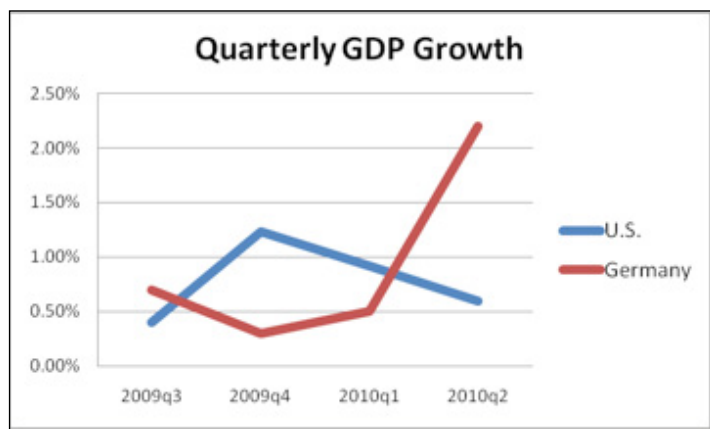
e21 Staff Editorial | August 16, 2010

In the second quarter of 2010, the German economy grew by 2.2%, the fastest rate since the old West German economy was integrated with the poorer, less productive, formerly communist East Germany. Since Eurostat reports growth rates on a quarterly basis, there is some risk that the significance of this “2.2% economic growth rate” could be lost in translation. Were Eurostat to use annualized rates like the United States’ Bureau of Economic Analysis (BEA), the German growth rate would have been 9.1%, which means the German economy grew nearly four-times faster than the 2.4% annualized growth rate recorded by the U.S. economy in the second quarter (Eurostat quantifies the U.S. growth rate as 0.59%). Over the twelve months ending in June, the German economy grew by 3.7%, half a percent faster than the 3.2% rate recorded by that of the U.S. More significantly, German growth has accelerated at the same time as growth in the U.S. has slowed markedly (see graph). After a tepid recovery from a deeper recession, the German economy seems to have achieved an “escape velocity,” which – to borrow a term from Larry Summers – has thus far eluded the U.S.

Last week, the Federal Reserve noted that the “pace of recovery in output and employment has slowed in recent months,” which was used as justification for a decision to move to a more accommodative monetary policy stance. Conversely, in its August statement the European Central Bank (ECB) pointed to a “strengthening” economy, with robust growth in the second quarter of 2010 and “better than expected” preliminary data for the third quarter. As the U.S. Bureau of Labor Statistics (BLS) reported the U.S. lost 131,000 jobs in July, the German government reported that its unemployment rate fell to 7.6%, just above where it stood prior to Lehman’s bankruptcy filing.

For months, the conventional wisdom had been that the feckless European governments were risking a double-dip recession by prematurely removing fiscal stimulus. In conjunction with a weak banking sector and overly indebted governments at the periphery (Greece, Spain, Ireland, and Portugal), Europe was supposed to be an anchor on global economic growth, not an engine. Why has the German (and broader European) economy sizzled at the same time as the much touted “Summer of Recovery” in the U.S. has fizzled?

First, one must acknowledge that stimulus in the U.S. provided a large boost to the economies of major exporters to the U.S. In June, the U.S. trade deficit increased by nearly 15% to \$62 billion. An increase in the budget deficit to fund stimulus results in an increase in the trade deficit, and the trade deficit subtracts from GDP. As economist John Cochrane puts it, belief in the efficacy of government expenditure as economic stimulus requires a world



where “people make plans to consume more, invest more, and pay more taxes with the same income (emphasis added).” The “same income” point is significant because an increase in consumption for a given amount of national income naturally results in a larger trade deficit. The increase in aggregate consumption not only increases spending on imports, but also increases domestic spending on goods and services that would have otherwise been exported (see Tony Makin’s chapter).

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Although no breakdown is yet available, most analysts anticipate that a major driver of the German economic expansion was an increase in net exports. Part of this is due to the decline in the value of the euro, which made German-produced goods less expensive, but some of it is directly attributable to stimulus spending in the U.S. and China. When a hypercompetitive, high-end manufacturing base like Germany sees major trading partners increase government expenditure, the optimal policy response is to do nothing. Some of the increase in external demand will translate to increased exports, providing a boost to the domestic economy without a penny of additional borrowing.

To the extent the Obama Administration comments on the strength of the German economy, it is likely to cast Germany as an obdurate free-rider that takes advantage of the U.S. stimulus and thwarts necessary “global rebalancing.” As Treasury Secretary Geithner has emphasized, a major objective of U.S. economic policy is to end the trade patterns of the past decade so “one country, or group of countries, does not consume in excess while another set of countries

produces in excess.” Germany is likely to be viewed as undermining this effort by failing to boost its domestic demand through additional government stimulus.

While the Obama Administration’s critique is reasonable from a raw arithmetic standpoint, blaming Germany’s robust growth on its failure to stimulate domestic consumption rings hollow. As the International Monetary Fund (IMF) explains in its 2010 review of the German economy, “Germany’s strong export orientation stems from the openness of its economy, its long-standing manufacturing traditions and its competitiveness in global markets.” After enduring nearly a decade of slow growth and low inflation, Germany has disinflated its way to an extremely competitive position thanks to painful labor market reforms. The cost of one hour of labor in Germany is now extremely low relative to the economic value added in that hour. Better coordination of public expenditures is not going to erase Germany’s huge competitive advantage in high-end manufacturing.

The German emphasis on competitiveness and the Obama Administration’s obsession with demand management captures well why these economies are moving at such discrepant speeds. The Obama Administration proposes significant tax increases on consumers and small business owners (most small business income is reported by taxpayers in the top two personal income tax brackets that are set to rise substantially in 2011), but is willing to spare no expense to prevent any contraction of state and local payrolls. Rather than focusing on public support for consumption expenditure, the Obama Administration should be more concerned about U.S. competitiveness and productivity. As former IMF Chief Economist Ken Rogoff recently wrote, the Obama Administration’s preferred narrative of

the Great Depression – where premature end to stimulus resulted in the 1937 double-dip – totally ignores how the increase in the “role of the state in an often chaotic and unpredictable fashion” suppressed private sector spending and investment. The monomaniacal focus on demand stimulation inures Administration officials to policies that sow uncertainty and slow the private sector’s recovery.

How is the German economy benefiting from the expansionary effects of fiscal consolidation? For more than thirty years, economists have pointed to the “fiscal illusion” on which stimulus depends. Going back to John Cochrane’s formulation, fiscal stimulus depends on households and business being ignorant to, or ignoring the fact that, debt-financed government expenditure eventually requires higher taxes to pay back the borrowing. If businesses and households recognize this and adjust their investment and consumption accordingly, a dollar of stimulus spending could contribute less than a dollar to GDP after accounting for the reduction in private sector consumption and investment. Research has found that as public debt levels increase, the private sector response to additional stimulus is more pronounced. Eventually, the decline in investment and consumption could exceed the positive economic contribution of the stimulus. In these cases, the government can actually increase output by reducing public spending and cutting its budget deficit (see the cases of Denmark, Ireland, Sweden, Canada, and Norway, among others).

In June, the German government announced an austerity package that provided the private sector with a clear and unambiguous message that public debt levels would not grow unsustainably. This likely instilled confidence in the private sector by reducing households and businesses’ estimates of the burden of government, which leads to an increase in

consumption and investment.

Ironically, the recent enactment of the \$26 billion bill to increase aid to states in the U.S. likely help back private sector growth rather substantially in many states. Empirical work from the IMF has found nonlinear responses from households as budget situations deteriorate. Simply put, the private sector responds to an additional dollar of debt much differently depending on the perceived sustainability of public finances. In states like California, where the deficit is exceedingly large and of a structural nature, federal funds allow state officials to delay the day of reckoning. This may allow more state workers to remain employed, but does nothing to attenuate the uncertainty facing businesses concerned about how tax rates will be adjusted to close the deficit. While the reduction in public sector payrolls absent stimulus would undoubtedly crimp demand. This is likely more than offset by the private sector investment and consumption lost from a continuation of the unsustainable status quo. In these situations, large spending cuts can offer the most reliable stimulus because of the signal to the private sector that less of its future earnings will be needed to finance government.

It has been distressing to watch analysts blame the lackluster recovery in the U.S. on an insufficiently large stimulus. Both historical and contemporaneous data suggest that the problem may just be the broader concept of a debt-financed stimulus. The German GDP growth rate is an important reminder to U.S. policymakers that a dynamic system as complex as the U.S. economy cannot be reduced to simple algebraic equations that suggest the road to economic growth is paved through increasing amounts of public expenditure.