



Round 2 on Lessons from Germany

e21 Staff Editorial | August 31, 2010

U.S. commentators, like Jonathan Chait and Paul Krugman, have taken issue with holding out Germany's economic recovery as a success story – one that contains lessons for U.S. policymakers. Contrary to their claims, Germany's recovery does not appear to just be about trade flows and global demand for their manufactured goods. 50% of their second quarter GDP came from private sector consumption and investment growth.

[More salient to the current policy debate than Germany's "tepid recovery from a deeper recession," was the "escape velocity" the German economy seemed to achieve at the same time that the U.S. expansion was foundering.

To demean the significance of the explosive German growth in the second quarter of 2010 and the nearly 4% growth of the German economy over the past twelve months, proponents of government spending-fueled prosperity point to the fact that the recession in Germany was deeper and the initial recovery more modest. The deeper trough and "flatter" initial growth allows Jonathan Chait and Paul Krugman to point out that cumulative real German GDP growth has been roughly equal to that of the U.S. since the fourth quarter of 2007. The suggestion is that German economic performance has really been no better than that of the U.S. and any near-term figures that suggest otherwise are really just a reflection of the bounce off of the bottom in demand for manufactured goods.

As argued in an August e21 editorial, more salient to the current policy debate than Germany's "tepid recovery from a deeper recession," was the "escape

velocity" the German economy seemed to achieve at the same time that the U.S. expansion was foundering. The planned "summer of recovery" in the U.S. was based on a presumption that since most of the stimulus outlays were to be paid out in 2010, the supportive boost from increases in public expenditure would lead the economy's growth rate to accelerate in the second and third quarters of this year. Instead, growth fell to an annual rate of 1.4% in the second quarter as the stimulus failed to prove catalytic to private sector consumption and investment. This development is befuddling for some analysts. As economist Gerald Lyons commented in a recent story on the "surprise" slowdown, "normally at this stage of the recovery we see confidence returning, but that just isn't happening at the moment. Instead we see anxiety about the future and the outlook for sub-trend growth."

Were consumption and investment exogenous to public sector deficits (i.e. if fiscal policy had no impact on private sector behavior), it would be easy to determine the necessary size of deficit-financed public expenditure to achieve any target growth rate. The problem is that households and businesses incorporate fiscal policy changes into their thinking. Both theory and empirical research have found that large fiscal deficits erode consumer and business confidence. The response to the perceived decline in future income typically involves increases in precautionary savings and reductions in private investment. Both tend to persist until the government details how it intends to place public finances on a sustainable path. In some situations, large reductions in public expenditure can have an

expansionary impact because each dollar in public spending withdrawn from the economy is matched by more than a dollar increase in private consumption and investment. Specifying the private sector's reaction is difficult; for countries with low public debt levels and highly credible long-run fiscal policies, one dollar of government stimulus could "crowd in" private sector spending and increase output by much more than a dollar; at higher debt levels, or where medium term deficits are clearly unsustainable, the same deficit-financed stimulus policy could actually reduce output.

... it is precisely the exploding public debt ratios that Mr. Trichet identifies as the real cause of Japan's malaise and the greatest risk to Western economies today.

The Germans enacted a relatively large stimulus program (the proportion of tax cuts was twice as large as for the U.S.), but were extremely sensitive about not reaching the inflection point where a marginal dollar of stimulus would decline in effectiveness (or turn negative). The focus since the early part of the year has been on reversing stimulus, enacting credible government spending cuts, and encouraging the rest of the developed world to do the same. The result (coincidental or not), has been a return to pre-recession levels of business confidence, a 2.4% annualized increase in households consumption expenditures in the second quarter, and more than a 20% annualized increase in business investment. Although growth in net exports did boost GDP in the quarter, it accounted for only 36% of German second quarter GDP growth, less than the 50% contribution from private sector consumption and investment growth (excluding inventories). Were this simply about trade flows and demand for manufactured goods, the German economy would probably resemble that of Japan, where exports were up by more than 25%

(annualized) in the second quarter, but the economy remained stagnant due to contractions in consumer spending and private sector investment.

As German business confidence rose, U.S. small business confidence exhibited large declines. Data released August 30 by the Bureau of Economic Analysis (BEA) show that the average personal savings rate for the three months ending in July was up 11% from the average savings rate in the first quarter. Overall, average annualized personal savings is up 13% over this same period, suggesting modest income gains have been saved. Again, the decline in business confidence and uptick in savings could be coincidental and have nothing to do with concerns about increases in future tax rates or the expansion of government's involvement in the economy, but certainly these data points fit a pattern uncovered in previous empirical research.

The contractionary effects of deficit-financed stimulus were highlighted by European Central Bank (ECB) President Jean-Claude Trichet at the Jackson Hole conclave. While many commentators in the U.S. still depict the debate over stimulus as pitting sagacious "pure" economists that favor more deficit spending against the politically astute economic illiterates, Mr. Trichet explains that the Franco-German technocrats in Frankfurt view the economic literature as counseling steep budget cuts in the current environment. Many U.S. economists speak of the need to increase deficit-financed public expenditure to avoid a Japanese-style "lost decade", yet it is precisely the exploding public debt ratios that Mr. Trichet identifies as the real cause of Japan's malaise and the greatest risk to Western economies today. To those who believe sharp reductions in public expenditure are too risky, given overall economic weakness, Mr. Trichet responds that deficit-financed stimulus is unlikely to provide any measureable boost



to demand in the current environment because the government purchases are offset by reduced private expenditure. And on this point, Mr. Trichet even goes even further:

There is the additional argument positing that credible fiscal deficit reductions through expenditure cuts lead the private sector to expect a lower future tax burden, especially when the nature of the cuts make future tax reductions more likely. This can generate higher consumption expenditures and more investment.

Lest anyone believe Mr. Trichet was talking about modest cuts to public expenditure to assuage irrational markets, he went on to suggest that cuts to government spending should be sufficient to reduce debt-to-GDP ratios by 30 percentage points over the medium term. Mr. Trichet cites numerous examples where cuts of this magnitude have resulted in improved short-run economic performance. That it takes a French lifetime bureaucrat to travel to the American West for these words to be spoken at a U.S. policy symposium says something fairly profound about the current state of policymaking in the U.S.

Mr. Trichet's comments are also particularly revealing when juxtaposed with specific statements by commentators like Mr. Krugman (here and here), who would rather see the U.S. government do "everything [it] can" now (since the stimulus to-date has been too small). Sadly, Mr. Krugman is not directing U.S. policymakers to improve business confidence or use tax policy to spur job-creating decisions by the private sector. And, even when tax policy is referenced it has generally been about how to raise taxes on would be job creators. Mr. Trichet's point about how private sector expectations of future tax rates can impact consumption and investment today are certainly worthy of more attention in the U.S. right now.

Whether or not the discrepant second quarter growth

rates between the U.S. and Germany represent a "natural experiment," it is clear that the divergence in policy views between Washington on one hand and Frankfurt-Berlin on the other have not closed. More data are to come. Stay tuned.