Taking The German Recovery *Less Seriously*

A counterintuitive view.

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The good news on the German economy just keeps on coming. GDP growth in 2006 and the first half of 2007 exceeded all forecasters' expectations by far. Unemployment has fallen further and faster than even the heartiest advocates of labor market reform had hoped. Germany's famed six economic institutes have now started competing over who can raise their economic forecasts the most, instead of who can be the gloomiest. And all this has come at a most fortuitous time for the world economy, when the U.S. growth rate (and thus imports from the rest of the world) is finally slowing, and the world needed another growth engine to carry the load. It seems a far cry from just two years ago when books about Germany's economic malaise or decline or even crisis dominated the country's bestseller lists.

While the benefits of German economic recovery are real and welcome, no one should attribute much lasting meaning to today's German economic recovery. German real per capita GDP—the measure that most closely tracks economic welfare—will not keep growing annually at rates well above 2 percent (even if that is what Germany will average over the course of 2006–08), and Germany will remain a laggard in productivity growth compared to other rich economies that save and invest as much is it does.

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Trade vs. Growth

Germany's preoccupation with remaining the world export champion is also quite misleading. There seems to be a **Dirk Nowitzki** fallacy at work. If people were to say, "Because Dirk Nowitzki of the Dallas Mavericks won the NBA's Most Valuable Player award, all German people are really good basketball players," we would dismiss that as silly. Yet, if we look at the corporate sector in Germany, there is this tendency to reason backwards from individual exporters. Because there are a couple of little machine tool companies in Baden-Württemberg that happen to make some exports to China, advocates of the Mittelstand argue everything is okay. But this doesn't really mean anything about the corporate sector generally, and there is no correlation between how much a developed economy exports over the long term and how fast it grows.

—A. Posen

Dirk Nowitzki *of the Dallas Mavericks.*

JONATHAN POWELL

Does the recent growth surge mean that the German economy has changed a great deal for the better? Or does it mean that all the diagnoses of doom and gloom were misplaced? Unfortunately, the answer to both of these questions still appears to be no, even taking into account the latest positive data. Yet, even though the mainstream negative assessment of Germany's long-term economic prospects remains correct in its bottom line, that appraisal holds for different reasons than those usually cited.

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Remember that Germany over 1991–2005 averaged only 1.4 percent per capita growth, despite positive demand shocks from first the post-unification boom at home and then the growing world economy of the last several years. If Germany was flat on its back for fifteen years, the idea that when the world is booming for many years straight at a level that hasn't been seen since the 1950s, it somehow manages to get off its back for a couple of years, should not be so surprising. Similarly, the current already-peaked cyclical recovery there will not bring the long-run trend up very much, and is not in itself evidence of a structural change. So, no, German real potential growth has not risen and is still only 1.5 percent or less per capita, and that is the rate at which we would expect Germany to grow on average including even these boom years.

As growth theory since the work of Robert Solow informs us, an economy's sustainable rate of per capita output growth rises as its workforce's quality is improved by education and training, as technological progress occurs and is adopted by businesses, and as investment adds to the stock of

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capital and enables it to absorb new technology. On every one of these fundamental counts, Germany continues to underperform—especially given its high savings rate and low inflation which should provide ample inputs to generate useful investment in human and physical capital. Obviously, labor force growth does nothing directly for per capita or for productivity growth, so the blame for the economy's low potential cannot be shifted to German demographics. Similarly, real interest rates remain low and exports remain high, so the usual excuse of high taxes driving fiscal and labor cost excesses does not hold up. It is failures in the German private-sector allocation of and returns to capital that are at work and that are still waiting to be addressed by increased market discipline or enforced liberalization.

Education and training was supposed to be a key advantage of the Germany economy, deploying the famed "dual system" to combine vocational and lifelong learning along with extensive public education and universities. Yet it has failed on every level. The PISA exams comparing primary school student achievement in reading and mathematics across countries revealed that German primary schools deliver results far below the OECD average. German universities have suffered an exodus of the best students and professors, are overwhelmed by huge numbers of unmotivated enrollees compared to the available infrastructure and faculty numbers, spend a tenth as much per graduate student as the United States does (with the logical diminishment of research), and, like all other competition-free tertiary education systems, fail to generate adequate numbers of graduates in the necessary fields. The vocational training system has proven inflexible, unable to adapt to changing industrial needs, much like the static companies and unions it serves.

And we know that private investment—residential and corporate—not only has been low in Germany for years, but that investment growth has still lagged the current recovery. In the United Kingdom and the United States, recent sustained rises in productivity growth rates were preceded by fixed investment and technological adoption, and in Japan the last few years' boom has been investment-driven while the economy adds new capital in restructured industries. In all these cases, investment was a marker of corporate adoption of best practices and utilization of information technology. The absence of at least a significant pick-up in German corporate investment at present, let alone any catch-up growth in replacement of depreciated capital (as in Japan), is a fundamental reason to be suspicious that the current German recovery is only cyclical in nature and does not reflect lasting improvements in productivity. Throw in the global availability of cheap capital fueling investment booms almost everywhere else in Europe, and the dysfunctionality of the German corporate sector is even more evident.

The good news about the rapid decline in unemployment in Germany to levels below those seen in the last recovery also raises doubts about the sustainability of Germany's higher growth rate. If an increase in a country's growth rate is due to an increase in potential output rather than just absorption of slack, it usually shows up in an increase in labor productivity growth. The economy starts producing more with the same number of workers and other inputs, and that in turn leads to demand growth

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(through higher wages and profits), and then to greater use of labor as the economy expands. In Germany at present, again the sequence was wrong if potential has improved. As soon as the economy started to pick up, German companies had to add a lot of workers, that is, labor input, to generate a small increase in production, which is the very opposite of productivity growth.

Put another way, mainstream economists usually examine so-called Okun coefficients of how much unemployment changes when an economy is growing faster or slower than at its potential rate—and the coefficient for Germany has risen in this recovery. This rise means that Germany has not only been growing well above potential (to cause such a drop in unemployment) but it needs to add more labor hours to increase growth a given amount than it used to. Part of this rise in employment certainly reflects the labor reforms to date, irrespective of the productivity aspect, but in a sense that is the point. The labor reforms can add to the amount of hours worked at a given wage, but that at best is a one-time increase in the economy's size, not a source of sustained growth.

Germany's preoccupation with remaining the world export champion is also quite misleading. There seems to be a Dirk Nowitzki fallacy at work. If people were to say, "Because Dirk Nowitzki of the Dallas Mavericks won the NBA's Most Valuable Player award, all German people are really good basketball players," we would dismiss that as silly. Yet, if we look at the corporate sector in Germany, there is this tendency to reason backwards from individual exporters. Because there are a couple of little machine tool companies in Baden-Württemberg that happen to make some exports to China, advocates of the Mittelstand argue everything is okay. But this doesn't really mean anything about the corporate sector generally, and there is no correlation between how much a developed economy exports over the long term and how fast it grows.

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Thus, no one should be confused or satisfied by the current cyclical recovery, least of all German citizens, welcome though it is from a global perspective. Germany's potential growth rate and therefore its long-term prospects remain poor, just as the mainstream view had it before the positive surprises of the last five quarters. But observers also should recognize where the current upswing demonstrates that many common economic policy beliefs in and about Germany are mistaken. In particular, labor market and tax reforms alone, which already have been implemented to a large degree in Germany, do not generate sustained productivity growth on their own. The real structural reform agenda, which is about increasing efficiency in the German corporate and financial sectors, remains to be tackled. So the German Grand Coalition should not allow recent temporary export success to be used as an excuse to leave the country's low returns on capital unaddressed. ◆