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The naive belief in eternal economic expansion

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Given that in the meantime most official forecasters agree with us that the Germans will suffer at least a technical recession, even German politicians and commentators are starting to join the so far mainly Anglo-Saxon chorus, asking for countercyclical fiscal measures. In our view the government should only act if there is clear evidence that we might be at the brink of a deep recession. Despite the undoubtedly massive economic policy uncertainties we do currently not expect such a scenario.

Recently, Anglo-Saxon investors tend to shake their heads at those behind-the-times German economists who still refuse to believe that Germany should urgently put together a huge fiscal stimulus package. Particularly if said economists (for example, we at Deutsche Bank) were among the first to sound the alarm about a potential recession back at the beginning of this year.[Focus Germany, Feb. 5, 2019: The R-question] By now, the German government, the Bundesbank and some research institutions also expect at least a technical recession, i.e. another GDP contraction in Q3 following a decline of -0.1% in Q2.

Against this background, the ECB, the IMF and the Eurogroup ministers of finance are wondering what on earth the German government is waiting for. US Nobel Prize winner Paul Krugman even believes that Germany's "fiscal obstinacy" is one of the main reasons behind the woes of the global economy. [1] With Germany contributing only 3.2% to global GDP (on a PPP basis), this view appears a bit exaggerated, though.

Longest boom in 50 years is approaching its end

While German economics minister Peter Altmaier is against old-school stimulus packages, he wants to avoid a recession at any cost. In fact, he has called preventing a recession the essence of "statesmanship".[2] Quite rightly, he has pointed out that Germany has been enjoying a (remarkably long) ten-year expansion, which he would like to extend further. Business cycle theory tells us that an upswing becomes a boom when the current rate of growth exceeds the trend rate and the capacity underutilisation of the preceding downswing is overcome (positive output gap). The IMF, the OECD and the Bundesbank all agree that this has been the case in Germany since 2014. This means that the output gap has been positive for the longest continuous period in 50 years. Only the reunification boom, which started back in 1988, can compare.

“Globalsteuerung” of the 1960s ended in stagflation

Similar to the belief in a perpetual motion machine in physics (which runs counter to the first law of thermodynamics), a number of policymakers and economists believe that smart policies (or “statesmanship”) can lead to a perpetual expansion and the elimination of the downswing part of the economic cycle. Given the declining trend growth these downswings will actually become more likely to result in negative growth rates. In fact, German economics minister Karl Schiller implemented what he called “macroeconomic steering” (Globalsteuerung) in the 1960s to prevent recessions by fine-tuning the economic cycle. However, macroeconomic steering did not have the desired effect. Instead, it led to the stagflation of the 1970s and 1980s, i.e. the worst of all worlds, in which unemployment, inflation and government debt rose strongly.

While the government certainly should intervene in case of a deep recession ...

Surely policymakers and their economic advisors have become much cleverer in the meantime, have they not? And their success in preventing economic Armageddon after the global economic and financial crisis has shown that countercyclical policies work, has it not? The coordinated global monetary and fiscal policy response in 2009/2010 was certainly both necessary and effective. Global trade had collapsed around the turn of the year 2008/09 and shrunk by roughly 15% within only three months. The global equity price slide pointed to a massive loss of confidence, and government demand successfully offset the collapse in private-sector demand, exactly as doctor Keynes had prescribed.

... it rarely succeeds in engineering an orderly retreat during the upswing

However, many governments missed their exit cue after the imminent crisis was over. Global government debt has risen by 23.5 pp since Q3 2008, despite having receded by close to 7 pp during the last three years. Global indebtedness of the non-financial sector has even climbed by 36 pp, from 197.7% of GDP in Q3 2008 to 233.7% lately – not least due to persistently low key interest rates. The US, from where the loudest calls for German “deficit spending” are emerging, have engaged in a veritable debt orgy. According to CBO estimates, government debt will reach the threshold of USD 1 trn (!) in FY 2020. Absent legal changes, debt will rise by 15 pp of GDP during the coming ten years, and if things go badly, by as much as 27 pp.

Do the Germans have a problem with debt?

The German word “Schuld” has two meanings: “debt” and “fault”. This is something even those critics who do not know German (and often do not know much about Germany either) have learned. They believe that the homonym aptly describes the German obsession with debt.

“Money for nothing” – should the government make a grab for it?

In fact, they argue that this collective paranoia has some masochistic characteristics. After all, the government might make use of negative interest rates to raise capital on the market and fund growth-supporting investments in education and infrastructure, which came practically for free as they induce higher GDP growth in the future. Besides private-sector investment, better general education and a modern infrastructure are doubtless important preconditions for sustainable growth. And Germany certainly could do better in this regard, even though the picture of a “crumbling infrastructure”, as Professor Krugman writes in his remote analysis, is certainly exaggerated. The true art is not to satisfy short-term political interests by simply providing indiscriminate subsidies or make investments that turn out to be useless later on. Against the background of massive structural change, the key challenge is to identify those investments that really support potential future growth and avoid making election gifts and engaging in political patronage.

Potential beneficiaries are slow to use available funds

According to the national accounts, the government registered a financial surplus of EUR 45.3 bn or 2.7% of GDP during H1 2019. As a rule, the figures are lower in H2, and weaker growth is already affecting tax revenues. Nevertheless, the surplus shows that Germany has enough money to increase government investment, even without taking out new debt. The real bottlenecks are in the areas of planning and claiming the available funds. CDU budget expert Eckhardt Rehberg recently listed numerous special support programmes for kindergartens, digitalisation or climate protection that are still sitting on billions of unclaimed funds.[3] The reasons are complicated planning procedures, obstacles stemming from Germany’s federal organisation structure or delays caused by citizens’ protests.

Half of the increase in government investment ends up in higher prices

At the same time, capacity utilisation is still very high, above all in the construction sector. Since 2016, aggregate government investment has risen by almost 4 ½% p.a. in real terms. A closer look reveals that the deflator, i.e. the rate of inflation, for state investment expenditure has steadily increased from 1.3% in 2016 to more than 4% in H1 2019 during this time. Put differently: Almost half of the increase in government investment has recently only helped to fuel inflation. In residential construction, almost two-thirds of the nominal year-on-year increase of 8.3% in H1 were gobbled up by higher prices, which means that public investment increased by only 3.4% in real terms.

Right now, stimulus policies are unnecessary; what is needed is a policy to sustain growth

This illustrates quite well that a stimulus package is currently unnecessary; indeed, it would be tantamount to a waste of tax money. Rather, the government should continue to increase investment in education and infrastructure steadily and complement these efforts with a prudent policy to promote Germany as a business location. This would really help to prop up growth in the long run.

[1] New York Times, 19 August 2019
[2] Spiegel Online, 23 August 2019
[3] Frankfurter Allgemeine Zeitung, 19 August 2019

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