



49

AICGSPOLICYREPORT

**THE END OF THE YEARS OF PLENTY?
AMERICAN AND GERMAN RESPONSES
TO THE ECONOMIC CRISIS**

S. Chase Gummer
Jacob Funk Kirkegaard
Tim H. Stuchtey



American Institute
for Contemporary
German Studies

JOHNS HOPKINS UNIVERSITY

The American Institute for Contemporary German Studies strengthens the German-American relationship in an evolving Europe and changing world. The Institute produces objective and original analyses of developments and trends in Germany, Europe, and the United States; creates new transatlantic networks; and facilitates dialogue among the business, political, and academic communities to manage differences and define and promote common interests.

©2011 by the American Institute for Contemporary German Studies

ISBN 978-1-933942-35-3

ADDITIONAL COPIES:

Additional Copies of this Policy Report are available for \$10.00 to cover postage and handling from the American Institute for Contemporary German Studies, 1755 Massachusetts Avenue, NW, Suite 700, Washington, DC 20036. Tel: 202/332-9312, Fax 202/265-9531, E-mail: info@aicgs.org Please consult our website for a list of online publications: www.aicgs.org

The views expressed in this publication are those of the author(s) alone. They do not necessarily reflect the views of the American Institute for Contemporary German Studies.

TABLE OF CONTENTS

Foreword	3
About the Authors	5
Executive Summary	6
Zusammenfassung der Studienergebnisse	7
Germany: Beggar Thy Neighbor or Simply Better Than Its Neighbors?	11
Different Circumstances Demand Different Solutions: The Diverging Policy Responses to the Great Recession in the United States and Germany	23



FOREWORD

The economic and financial crisis continues to be a challenge for the U.S. and Europe. Declining fiscal revenues, mounting budget deficits, and the euro crisis have led to different reactions across the Atlantic. Germany is becoming the European leader in arguing for strict fiscal discipline, whereas other European Union members are arguing for more help from the EU and ECB. The United States is afraid that a prolonged euro crisis will affect its own rather tenuous economic recovery.

In this Policy Report, Dr. Jacob Funk Kirkegaard from the Peterson Institute for International Economics and Dr. Tim Stuchtey and Dr. S. Chase Gummer from the Brandenburgisches Institut für Gesellschaft und Sicherheit gGmbH (BIGS) analyze the policy responses of Germany and the United States to the continued economic and financial unrest. Dr. Stuchtey and Dr. Gummer examine the origins of Germany's economic policy and order as well as the current role Germany is playing in the European economy. They also analyze implications for European integration, security issues, and the transatlantic partnership. Dr. Kirkegaard argues that because the Great Recession had different economic effects in Germany and the U.S., policymakers' responses differed as well. But, he argues, once the economic circumstances converge, economic policy in Germany and the U.S. will also become similar again.

This Policy Report is the conclusion of a year-long project in cooperation with BIGS, which focused on the economic crisis and recovery; economic policy choices and challenges in the U.S. and Germany; and implications for other policy areas, especially security. AICGS is grateful to the support of the Transatlantic Program of the Government of the Federal Republic of Germany through funds of the European Recovery Program (ERP) of the Federal Ministry of Economics and Technology and the AICGS Business & Economics Program for their support of not only this Policy Report, but the entire project. Other publications stemming from the project are available on AICGS' website.

The Institute would also like the authors of this Policy Report for sharing their analysis and Jessica Riester for her work on this publication.



Jack Janes
Executive Director

ABOUT THE AUTHORS

Dr. S. Chase Gummer completed his PhD in history at Georgetown University in 2010. His main focus centered on international financial and economic history, and his dissertation analyzed the diplomatic relations between Germany and the Ottoman Empire before the First World War. During the course of his PhD, Dr. Gummer worked for a Berlin-based consulting firm, leading projects in both the private and public sector. Before beginning his PhD, he worked in the office of Global External Affairs and Public Policy at Daimler Chrysler AG, where he was responsible for global economic surveillance. He also received an M.A. from the School of Foreign Service at Georgetown in 2004. Dr. Gummer has been a Visiting Fellow at BIGS from April to December 2011 and worked on the project “Global Economic Imbalances: A Question of National Security?”.

Dr. Jacob Funk Kirkegaard has been a research fellow at the Peterson Institute for International Economics since 2002. Before joining the Institute, he worked with the Danish Ministry of Defense, the United Nations in Iraq, and in the private financial sector. He is a graduate of the Danish Army’s Special School of Intelligence and Linguistics with the rank of first lieutenant; the University of Aarhus in Aarhus, Denmark; and Columbia University in New York. He is author of *The Accelerating Decline in America’s High-Skilled Workforce: Implications for Immigration Policy* (2007) and coauthor of *US Pension Reform: Lessons from Other Countries* (2009) and *Transforming the European Economy* (2004) and assisted with *Accelerating the Globalization of America: The Role for Information Technology* (2006). His current research focuses on European economies and reform, pension systems and accounting rules, demographics, off-shoring, high-skilled immigration, and the impact of information technology.

Dr. Tim H. Stuchtey is managing director of the Brandenburgisches Institut für Gesellschaft und Sicherheit (BIGS), a homeland security think tank based in Potsdam, Germany. At the same time he is a Senior Fellow and Director of the Business & Economics Program at AICGS. He works on various issues concerning economic policy, the economics of security, the classic German “Ordnungspolitik,” and the economics of higher education. Dr. Stuchtey studied economics with a major in international trade and international management and graduated in 1995 from the Westfälische Wilhelms-Universität in Münster. In 2001 he earned a Ph.D. from the Technische Universität Berlin in economics, which he obtained for his work in public finance and higher education policy. He worked as an economist for the German Employers Association and as a university administrator both at Technische and Humboldt-Universität Berlin. He was also the managing director for the Humboldt Institution on Transatlantic Issues, a Berlin-based think tank affiliated with Humboldt-Universität. He has published a number of articles, working papers, and books on higher education governance and finance and on other questions of the so-called “Ordnungspolitik.” He is a frequent contributor to *The AICGS Advisor*, writing mainly about the financial crisis, the global recession, and the political attempts to return to a stable growth path.

EXECUTIVE SUMMARY

■ The euro crisis and Great Recession have contributed to a renewed focus on Germany. Within Europe, observers question whether Germany, as a leading exporter, has profited from the euro and destroyed the competitiveness of the periphery, or if Germany's economic strength and leadership role is more a result of its successful economic order. The present political process to save the euro has contributed to a decrease in enthusiasm for further European integration among people.

■ German economic policy, rooted in the principles of Ordo-Liberalism, has historically emphasized a policy of cash reserves and mercantilism (accumulation of economic surpluses) together with strong state institutions. The formal articulation of Ordo-Liberalism in the postwar period combined order and economy to establish a formal economic order in which states and markets interact in such a way that guarantees individual freedom and market efficiency, but protects against state interference on behalf of narrow interest groups. Fundamental principles are: functioning price mechanism, a stable monetary policy, a guarantee for open markets, private ownership, and freedom of contract, as well as individual and institutional liability, and a policy of steadiness.

■ Keynesian stimulus programs implemented in the 1970s and 1980s did not lead to economic growth in Germany. Reunification in 1990 caused a significant increase in the federal deficit, failed to jumpstart the economy, and led to recession in 1992. Germany then exported its inflationary problems from reunification to the EU, affecting plans for the single currency and ultimately leading Chancellor Kohl to abandon the Deutsche Mark. Budget deficits persisted until 2007, only to have the recession undo the balanced budget again in 2008.

■ The thinking in Germany that imports are bad for the economy and exports are good has created broader problems. The euro crisis is also a result of Germany's sustainable trade surplus. Because Europe's current account is almost balanced, Germany's trade surplus must be balanced with deficits from others in the eurozone. In order to buy exports, importing nations must also import capital mostly from foreign banks. The importing country continues to owe Germany as they run current account deficits; those debts end up on the balance sheet of the banks from surplus countries. If the imbalance continues, the deficit country becomes over-indebted, defaults, and creditor banks receive less of the debt they are owed. Banks with insufficient capital must then be rescued. Ultimately this is a redistribution from the general tax payer to the owners of and employees in the export industry.

■ If a deficit country cannot depreciate its currency, then they have three options to remove imbalances: 1. Keep wage increases lower than economically stronger regions; 2. Workforces can migrate to stronger regions; 3. Money transfer from faster growing regions to slower to support those that no longer are competitive. German policymakers probably prefer the migration option (based on their experiences with reunification).

■ Much as the U.S. is to the rest of the world, Germany has become the hegemon in Europe, and its power and influence is necessary to solve the crisis. Furthermore, the euro crisis presents broader security implications: economic decline is considered one of the biggest threats to world peace and the lack of funding for defense and security could prohibit Europe from sharing the burden to provide global security with the United States.

■ The causes and responses to the Great Recession varied in the U.S. and Germany. U.S. fell into recession due to declines in private consumption and fixed capital formation, whereas Germany was impacted because its exports fell faster than its imports.

■ Automatic stabilizers are stronger in Germany and weaker in the U.S. than the OECD average, meaning that the U.S. has relied more on fiscal stimulus and tax breaks to drive economic growth. However, looking at the relative scale of government stimulus, Germany's general government demand creation was more than twice the level of the U.S. after the recession began and has contributed positively to GDP. U.S. federal stimulus efforts have been undermined by cuts at the state and local levels.

■ U.S. unemployment is higher than in Germany despite Germany's comparatively deeper economic downturn. Germany's government-supported work schemes (short-term work, reduction in overtime hours) reduced hours worked rather than jobs. U.S. employers shed workers. Thus the U.S. has historic high unemployment and Germany has its highest employment rate ever.

■ Differences in central banks' roles and policies have been part of the varied responses across the Atlantic. Germany and the EU are under-institutionalized to handle a crisis of this magnitude. ECB members have the same amount of influence (same number of seats), giving Berlin less influence than in other EU institutions. Initially both the ECB and the Federal Reserve reduced interest rates dramatically. The Fed then acted to bail out key financial institutions. ECB faces daunting institutional obstacles and a more complex problem: it must consider multiple individual governments without exercising any central fiscal authority.

■ Looking ahead, political responses across the Atlantic will converge more when economic circumstances converge.

ZUSAMMENFASSUNG DER STUDIENERGEBNISSE

■ Die Euro Krise und die Große Rezession haben dazu beigetragen, dass Deutschland eine höhere Aufmerksamkeit als in der Vergangenheit durch die US-Medien und Politik erhält. Innerhalb Europas wird darüber diskutiert, ob Deutschland als führendes Exportland von der Einführung des Euro profitiert und die Wettbewerbsfähigkeit der Peripherie zerstört hat, oder, ob Deutschlands zurückgewonnene wirtschaftliche Stärke und Führungsrolle das Resultat seiner erfolgreichen Ordnung der sozialen Marktwirtschaft ist. Die laufenden Bemühungen, den Euro zu retten, haben dazu beigetragen, dass der Enthusiasmus für eine weitere europäische Integration nachgelassen hat.

■ Deutschlands Wirtschaftspolitik, die auf den Prinzipien des Ordoliberalismus basiert, hat historisch starken Wert auf eine merkantilistische Politik (der Akkumulation von Handelsüberschüssen) in Kombination mit starken staatlichen Institutionen gelegt. Der Ordoliberalismus der Nachkriegszeit vereinte Staatsrecht und Marktwirtschaft, um eine formale wirtschaftliche Ordnung zu schaffen, in welcher Staaten und Märkte miteinander auf eine Weise agieren, die individuelle Freiheiten und Markteffizienz gewährleistet, aber vor von Interessengruppen gesteuerten staatlichen Eingriffen schützt. Grundlegende Prinzipien des Ordoliberalismus sind: ein funktionierender Preismechanismus, eine stabile Geldpolitik, eine Garantie für offene Märkte, Privateigentum und Vertragsfreiheit, sowie individuelle und institutionelle Haftung und eine Politik der Stetigkeit.

■ Die keynesianischen Konjunkturpakete der 1970er und 1980er führten nicht zu ökonomischem Wachstum in Deutschland. Auch die Wiedervereinigung 1990 verursachte ein

beträchtliches Ansteigen des Staatsdefizits, schaffte es aber nicht, das Wirtschaftswachstum anzutreiben und führte 1992 zu einer Rezession. Deutschland exportierte dabei seine von der Wiedervereinigung ausgelösten Inflationsprobleme in die EU, beeinträchtigte dadurch die Pläne für eine Gemeinschaftswährung und veranlasste letztendlich Helmut Kohl dazu, die Deutsche Mark aufzugeben. Der Staat erwirtschaftete bis 2007 ein Haushaltsdefizit, und der dann ausgeglichene Haushalt wurde 2008 erneut durch die Wirtschaftskrise zunichte gemacht.

■ Die Annahme in Deutschland, dass Importe schlecht und Exporte gut für die Wirtschaft sind, hat zu Problemen für die Eurozone geführt und letztlich zur Eurokrise beigetragen. Da Europas Leistungsbilanz mit dem Rest der Welt weitgehend ausgeglichen ist, muss Deutschlands Überschuss mit Defiziten anderer Länder innerhalb der Eurozone ausgeglichen werden. Um die Importe finanzieren zu können, müssen die Defizitstaaten Kapital über ausländische Banken importieren. Die Defizitstaaten häufen so laufend Schulden an. Diese Schulden enden dann in den Bilanzen der Banken aus den Überschussländern. Wenn das Ungleichgewicht anhält, überschuldet sich das defizitäre Land, irgendwann kommt es zu einem Zahlungsausfall und die Gläubigerbanken erhalten weniger Geld zurück als ihnen ursprünglich geschuldet wurde. Banken mit ungenügendem Eigenkapital müssen dann vom Staat gerettet werden, was letztlich zu einer Umverteilung vom einfachen Steuerzahler hin zu den Eigentümern und Angestellten der Exportindustrie führt.

■ Wenn ein Defizitstaat seine Währung nicht abwerten kann, gibt es drei Möglichkeiten, das makroökonomische Ungleichgewicht zu beheben:

1. Die Lohnerhöhungen bleiben proportional hinter jenen der wirtschaftlich stärkeren Region zurück; 2. Es kommt zu einer verstärkten Migration von Arbeitskräften von den wirtschaftlich schwachen in die stärkeren Regionen und 3. Es kommt zu dauerhaften Geldtransfers von den Überschuss- zu den Defizitstaaten, um die Regionen der Währungsunion zu unterstützen, die nicht länger wettbewerbsfähig sind. Basierend auf den Erfahrungen mit der Wiedervereinigung werden in Deutschland wohl am ehesten die Migrationsströme akzeptiert.

■ Die Rolle Deutschlands innerhalb Europas ist vergleichbar mit jener der USA für die gesamte Welt; Deutschland ist nun der Hegemon in Europa und seine Macht und sein Einfluss sind notwendig, um die Krise zu überwinden. Darüber hinaus ergeben sich aus der Eurokrise auch Implikationen für die geopolitische und innere Sicherheit. Der wirtschaftliche Abschwung ist eine der größten Bedrohungen für den Weltfrieden und ein Rückgang der Verteidigungs- und Sicherheitsausgaben dürfte Europa zukünftig noch mehr davon abhalten, die USA bei der Gewährung der globalen Sicherheit zu unterstützen.

■ Die Ursachen und Reaktionen auf die Große Rezession variierten in Deutschland und den USA. Die USA gerieten in die Rezession, weil privater Konsum und Festkapitalbildung zurückgingen, wohingegen Deutschland betroffen war, weil Exporte schneller fielen als Importe.

■ Automatische Stabilisierer sind in Deutschland stärker und in den USA schwächer als der OECD-Durchschnitt, was bedeutet, dass die USA sich stärker auf fiskalischen Stimulus und Steuererleichterungen verlassen haben, um das Wirtschaftswachstum anzutreiben. Vergleicht man den relativen Umfang des von den Regierungen bereitgestellten Stimulus, war Deutschlands Nachfrageschaffung durch die Regierung zwei Mal so hoch wie die der USA, nachdem die Rezession begann, und hat sich positiv auf das Bruttoinlandsprodukt ausgewirkt. Die Stimulusbemühungen der USA wurden durch Einschnitte auf staatlichen und lokalen Ebenen beeinträchtigt.

Die Arbeitslosigkeit in den USA ist höher als in Deutschland und das trotz eines vergleichsweise stärkeren Konjunkturabschwungs in Deutschland. Deutschlands regierungsgestützte Arbeitsprogramme (Kurzarbeit, Kürzungen der Überstunden) haben eher die Arbeitszeit gekürzt als Arbeitsstellen. Arbeitgeber in den USA haben Stellen gestrichen. So kommt es, dass die Arbeitslosenquote in den USA auf ihrem historisch höchsten Stand ist und in Deutschland den niedrigsten Stand seiner Geschichte erreicht hat.

■ Unterschiede in der Rolle und Politik der Zentralbanken sind ein Teil der unterschiedlichen Reaktionen auf beiden Seiten des Atlantiks. Deutschland und die EU haben nicht die notwendigen Institutionen, um mit einer Krise dieses Ausmaßes umzugehen. Die Mitglieder der EZB haben alle das gleiche Maß an Einfluss (gleiche Sitzanzahl), wodurch Berlin weniger Einfluss als in anderen EU Institutionen hat. Anfänglich haben sowohl die EZB als auch die US-Notenbank (Federal Reserve) die Zinsen deutlich gesenkt. Die US-Notenbank hat danach wichtige finanzielle Institutionen vor dem Bankrott gerettet. Die EZB sieht sich gewaltigen institutionellen Schranken und einem komplexerem Problem gegenüber: Sie muss mehrere individuelle Regierungen berücksichtigen ohne zentrale fiskalische Autorität auszuüben.

■ Sobald sich die wirtschaftlichen Bedingungen einander annähern, werden sich in der Zukunft auch die politischen Reaktionen auf beiden Seiten des Atlantiks nähern.



GERMANY: BEGGAR THY
NEIGHBOR?

01

GERMANY: BEGGAR THY NEIGHBOR OR SIMPLY BETTER THAN ITS NEIGHBORS?

TIM H. STUCHTEY AND S. CHASE GUMMER

The sovereign debt crisis in the eurozone has not only renewed the focus on Germany and its role in Europe, but also shifted attention back to the internal macroeconomic imbalances within the eurozone. As Europe's largest economy, German economic strength, competitiveness, and financial muscle are key to solving the debt problems that have wrenched global markets and created increasing levels of uncertainty; yet German leadership has been criticized on both sides of the Atlantic as being either timid—or worse, self-serving and destructive. Critics charge that Germany has been too interested in courting domestic public opinion, which has led to half-measures that only prolong the crisis. No country has profited more from the common euro currency than Germany, but when push comes to shove, Germans will not bail out “Club Med” of southern Europe and reward lax fiscal discipline, although critics think it would be in their ultimate economic interest to do so.

Defenders argue that there are institutional and legal, not to mention economic, limits to what Germany can do to shore up the eurozone. Germany has achieved impressive results through a decade of wage restraint, labor market reforms, and a tightening budgetary policy. The trade surplus was not the result of any intentional policy but rather the by-product of a painful modernization of the German economy. Thus, while some of the eurozone member states overconsumed thanks to dramatically lower interest rates after the introduction of the euro, Germany entered the euro with an unfavorable exchange rate and suffered from a lost decade in which it was seen as the sick man of Europe. And now, without significant pressure for structural reform in the southern eurozone states, so the argument goes, Germany would be sacrificing its own economic stability for vague promises that might not come to pass. Many Germans fear that the fundamental basis for the

country's prosperity since World War II would be at stake, and thus the prospects for long-term economic growth. Rather than inflate its way out of the crisis, German policymakers would like to see their economic principles exported to the eurozone's periphery—not just their bailout funds.

So the question remains: has Germany profited disproportionately from the euro, destroying the competitiveness of the periphery and engaging in a form of beggar thy neighbor? Or is Germany simply better than its neighbors—with a more successful economic order, and suffers from the low euro through worsening terms of trade? In order to grasp these conflicting points of view, one must understand the historical context that informs the German economic order and the views of many German policymakers.

The Origins of German Liberalism: The Well-Ordered State

The roots of the liberal economic order in Germany run deep. Before the first German unification in 1871, the patchwork of principalities and princely states of the old Holy Roman Empire had one thing in common: the idea of a well-ordered state that attempted to protect its subjects from invaders and provide a rational economic framework for the development of commerce and trade. German universities were the intellectual home of mercantilism, a policy that advocated the accumulation of economic surpluses, for most states were small and relatively weak, requiring cash reserves in case of a rainy day.¹ In the 1870s and 1880s, a unified state under Otto von Bismarck went about strengthening a common German market under the principles of property rights, a transparent and functioning legal system, as well as a unified currency based on gold. Prosperity seemed limitless

at the turn of the last century as German trade and commerce expanded across the globe, and Germany's melding of strong state institutions with a liberal economic order was studied copiously by outsiders everywhere.²

The First World War smashed German prosperity and ushered in a period of crisis that not only brought hyperinflation in the early 1920s, but also led to an enormous concentration of wealth, impoverishing the middle class and exacerbating social tensions.³ When the Nazis came to power in the 1930s, the new regime intervened massively in the German economy, helping spur growth and rewarding obsequious industrialists with government contracts. The Nazis relied heavily on nepotism, oligopoly, and price controls, trying to achieve economic autarky during their murderous war that pushed the entire continent to the brink of destruction and spurred a wave of "hidden inflation" in the German war economy.⁴

Many of the architects of the postwar German economic order came of age during this period, when market forces and rule of law were subverted by what contemporaries called *die gelenkte Wirtschaft* ("the steered economy") of the Nazis. At the University of Freiburg, a group of lawyers and economists gathered to discuss many of the issues that had dominated discussion during the Weimar Republic in the 1920s as well: how could one develop rules to maintain social order yet guarantee a prosperous and free society? Known as the "Freiburg School" of economics, this collaboration led to a publication series *Ordnung und Wirtschaft* ("Order and the Economy") in 1937. Academics like Franz Boehm, Walter Eucken, Alfred Müller-Amack, and Hans Großmann-Doerth developed what came to be known as Ordo-Liberalism for its emphasis on establishing a formal economic order in which states and markets interacted in such a way that guaranteed individual freedom and market efficiency, yet provided protection against oligopolies and state interference on behalf of narrow interest groups.⁵

As a follower of the Freiburg School, Ludwig Erhard had the most lasting impact on Germany's successful re-integration into the Western European economy in the late 1940s. In 1948 he was appointed Director of the Administration for the Economy of the United

Economic Area, which would later become West Germany. In the summer of that year, Erhard engineered a partial return to a market economy, unilaterally liberalizing price controls as well as the rationing system in the western zones of occupied Germany. The introduction of a new currency, the Deutsche Mark, effectively ended the long run of wartime inflation by adhering to principles of steady monetary expansion in line with growth. When the Federal Republic of Germany was founded in 1949, Erhard became the first Minister of Economics in Konrad Adenauer's cabinet and helped implement a new economic order that has since been heralded as the foundation for the economic boom years in the 1950s. The so-called *Wirtschaftswunder* or "economic miracle" helped Germany regain its position as the second largest economy by the end of the 1950s and propelled Erhard into the Chancellery after Adenauer's retirement in 1963. Many Germans, therefore, regard the *Ordnungspolitik* or "policy of order" established during this period as the bedrock of German prosperity ever since.⁶

German *Ordnungspolitik* followed from seven fundamental constitutional principles that are captured in Walter Eucken's Basic Principles of Economic Policy published in 1952:

- **Price Mechanism:** Politicians should avoid policies that distort relative prices through mechanisms such as subsidies, tariffs, trade barriers, and monopolies.
- **Monetary Policy:** Price stability is crucial for both producers and consumers in making a liberal economy work, especially in Germany where the fear of hyperinflation loomed large in the 1940s and 1950s.
- **Open Markets:** This principle emphasized the virtues of competition, the dangers of cartels or monopolies, as well as the importance of free trade.
- **Private Ownership:** Property rights and the incentives of ownership are crucial to markets.
- **Freedom of Contract:** Another component of functioning markets requires that participants can freely enter contracts. Ordo-Liberals were most concerned with its abuse by monopolies.

■ **Liability:** The principle of liability ensures that contracting parties would act responsibly and be held accountable for their actions

■ **Steadiness:** A key method of maintaining public trust in the existing economic order was establishing a steady economic policy, which in concert with sound monetary policy, reduces risk in the decision-making for entrepreneurs, investors, and consumers.

Ordo-Liberalism integrated a host of lessons learned by German liberals in the first half of the twentieth century about the role of the state. The inflationary policy of the early Weimar republic, for example, had successfully undermined Germany's reparations payments to the Allies after the war in 1919 but at a high cost. The hyperinflation of 1923 had so thoroughly damaged the social fabric of German society that many liberals blamed it for the rise of the Nazis. World War II was such an unmitigated disaster that nobody in the postwar period wanted to replicate the Nazi regime's emphasis on aggressive state intervention and autarky. New institutions in the postwar era, like the Bundesbank and the Federal Antitrust Agency, provided for monetary stability and guaranteed competition. A social welfare system, whose origins dated back to the nineteenth century, helped mitigate the income disparities that arose in a dynamic market-based society. Erhard himself characterized the order he had helped create as the *Soziale Marktwirtschaft* or "Social Market Economy," emphasizing both markets as well as social cohesion. With wealth redistribution a key element of this new order, policymakers hoped to even out swings in the business cycle and provide incentives for long-term investment, while price stability would help encourage production. Ordo-Liberalism was, in many ways, a return to the success story of the pre-World War I era, when Germany was an open economy dedicated to free trade and clear—but limited—forms of state intervention. The well-ordered state had returned.

From Recession to Reunification: German Flirtations with Keynesianism

Bismarck, ever the realist, once quipped that having to go through life with principles was like walking through a dense forest with a long pole in one's

mouth. While Ordo-Liberalism undergirded the economic order of the Federal Republic, the Social Market Economy's emphasis on steadiness and limited intervention came under pressure in the 1960s and has faced challenges ever since. Erhard thought his system superior to the widely popular neo-Keynesianism of the postwar era, with its emphasis on counter-cyclical fiscal and budgetary policies to stimulate demand during a downturn. The reigning coalition government of Christian Democrats (CDU) and Liberal Democrats (FDP) were united in their view that any attempt to counteract the business cycle through deficit spending was dangerously inflationary, although monetary policy could provide incentives for investment in response to weak growth. Yet when faced with its first real recession in the postwar period in late 1966 and a growing state deficit, the CDU dropped the Liberals and brought in the Social Democrats (SPD), taking a fresh look at efforts to stimulate the economy. The SPD's new minister of economics, Karl Schiller, moved toward a form of Keynesian stimulus with the *Stabilitätsgesetz* ("Stability Law") of 1967, which increased taxes in good times to pay for the rise in unemployment benefits in bad times, and allowed the state to unleash government spending in a downturn. Faith in the state's ability to manage the economy through counter-cyclical measures continued on into the 1970s, even as inflationary pressures were rising. Chancellor Helmut Schmidt remarked that the German people would rather see 5 percent of inflation than 5 percent of unemployment. Yet Germany ended up having both, and a new government led by Helmut Kohl tried to return to the Ordo-Liberal principles of the 1950s and 1960s, focusing on shrinking the deficit, controlling inflation, and providing steadiness for production-led growth.

The Kohl government was part of the larger neo-liberal reaction to the stagflation of the 1970s found in the United States and Great Britain as well, yet Germany's celebration of the market was cut short by that momentous event of 1989: the fall of the Berlin Wall and the path to reunification. Instead of slashing budgets in the wake of communism's collapse (like the United States had done), the newly unified Germany faced a unique political and economic situation that led to a significant increase in the federal deficit. The Kohl government embarked on massive

public work projects in the East and extended social welfare benefits to the citizens of the German Democratic Republic, hoping for a quick convergence of East Germany's economy with the West. However, this deficit spending failed to jumpstart the economy, and most German economists regarded the effort as a failure. A construction boom in the East was followed by rising prices, higher interest rates, and a recession in 1992 that has provided a cautionary tale to policymakers ever since.⁷

Germany's post-reunification budget deficits also had serious pan-European implications. Germany exported the inflationary consequences of reunification to its European partners, briefly upending plans for a single currency (by forcing the British and Italians to exit the European Monetary System) before Kohl agreed to abandon previous German policy to the winds and surrender the Deutsche Mark. Most dramatically the increase in public debt necessitated by the large transfers to East Germany almost disqualified the Federal Republic from participating in the euro. Budget deficits have dogged the German government since 1989, and it was only in 2007 that Germany achieved a balanced budget before falling back into the red with the Great Recession of 2008.

The lesson learned by many German policymakers was that neo-Keynesian stimulus programs of the 1970s and 1990s did not lead to long-term growth, only worsened the government's fiscal situation, created inflationary pressures, and caused interest rates to rise. Even historically stimulus-friendly Social Democrats like Peer Steinbrück openly distained the "crass Keynesianism" of the American and British governments in 2008, and offered a revisionist account of the 1970s, claiming "government debt rose, and the downturn came anyway."⁸ Rather than concentrate on the short term through stimulus and loose monetary policy, German Ordo-Liberals think it much better for the state to provide steady investments in infrastructure, maintain price stability for long-term production, and let weak businesses fail so that workers can be re-absorbed into more productive sectors of the economy.

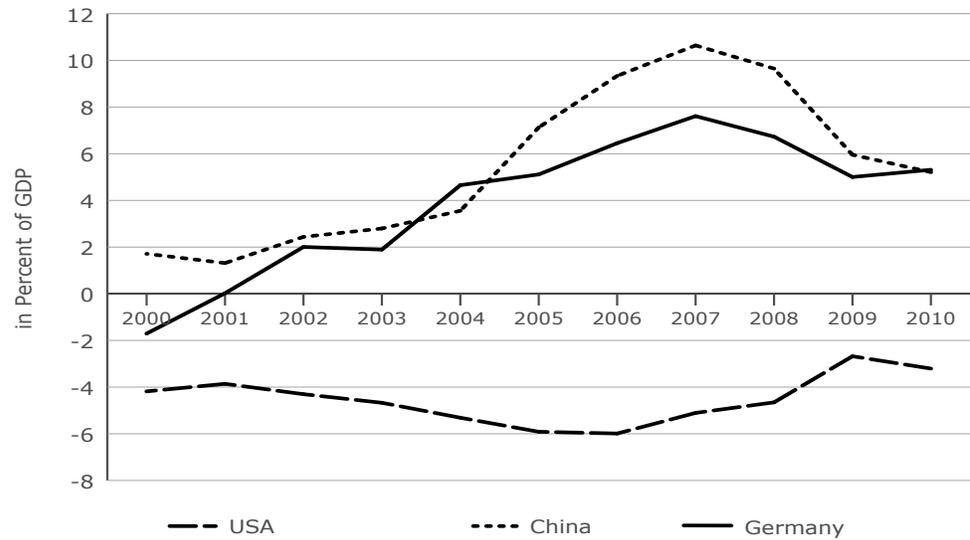
The Blame Game About Imbalances: Letting a Crisis Go to Waste?

German Ordo-Liberals see the United States risking its long-term wealth by trying to fill the large gap left by the indebted American consumer with fiscal stimulus and devaluation. If the underlying problem was caused by America's trade deficit with China, chronic overconsumption in the U.S., and chronic underconsumption in China, then further American consumption is no long-term solution. As the German finance minister Wolfgang Schäuble has put it: "you can't cure an alcoholic by giving him alcohol."⁹ The Americans should focus, instead, on infrastructure investment and internal reforms that increase the long-term productivity of their workers as well as promote fiscal responsibility. Instead of a burgeoning "currency war," in which the United States and China attempt to compete for competitive advantage through devaluation, or through a burgeoning industrial policy that was intimated with the bail-outs for the auto industry, the focus needs to be on fundamentals. German Ordo-Liberals believe the United States needs to go through a period of rebalancing, bringing domestic demand and production back into equilibrium. At the same time, the U.S. should help reign in financial markets by creating a global regulatory framework that promotes stability and eschews systemic risk. Thus, contrary to Rahm Emanuel's best efforts, they believe Americans are letting the crisis go to waste.

While Germans may harken back to their Ordo-Liberal "founding fathers" of the immediate postwar era as the right path forward for long-term stability, many outside observers take a different view. A good indicator can be found in *Foreign Policy* magazine's list of Top 100 Global Thinkers, who were asked whether they favor stimulus or austerity for the global economy; a large majority favors the former.¹⁰ Rather than trying to provide stability, Germany is tapping into another long-held tradition: mercantilism.

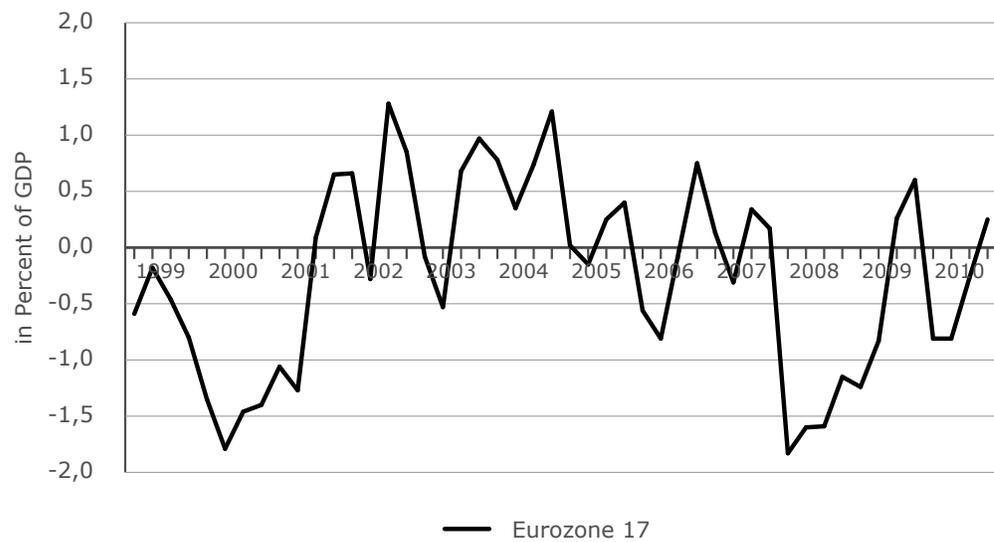
A quick look at Germany's trade balance over the past ten years shows increasing surpluses rivaled only by those of China. Together China and Germany are the largest exporters of manufactures and have massive surpluses of savings over investment. And just as China's growing surpluses are matched by

Figure 1: Current Account Balance as Percentage of GDP



Source: International Monetary Fund, "World Economic Outlook,"
<http://www.imf.org/external/pubs/ft/weo/2011/01/weodata/download.aspx> (19 May 2011)

Figure 2: Eurozone Current Account Balance



Source: European Central Bank, "Statistical Data Warehouse,"
http://sdw.ecb.europa.eu/quickview.do?SERIES_KEY=DD.Q.I6.BP_CU.PGDP.4F_N& (19 May 2011)

America's deepening current account deficit, Germany balances its trade surplus with the deficits from the usual suspects within the eurozone. Since all accounts must sum to zero, and the eurozone's current account balance with the rest of the world is negligible, Germany's surplus from trade results in growing deficits in other parts of the eurozone. The sovereign debt crisis is, in part, a result of these structural imbalances. Since Germany exports more than it imports, other nations have financed their import binge through capital inflows from the surplus countries. The growing imbalances within the eurozone have caused the deficit countries to become so indebted to a point at which they are unable to receive further capital from the financial markets.

At the same time, German and other European banks must write-down claims with the eurozone periphery, causing a credit crunch, which has spread throughout Europe. Yet Germany refuses to acknowledge that this has anything to do with its continuous current account surplus. Politicians from all major parties still hail the export strength of German industry as the *sin qua non* of German economic policy, hinting that imports are in some way "bad" for the economy. Anything that strengthens exports is considered good for the country because it creates jobs. This type of thinking is so ingrained that the domestic debate about education reform stresses the importance of language learning because it strengthens the German ability to export.

Export growth allows manufacturing to flourish. Business owners collect the rising profits and their employees benefit from rising wages. In order to be able to finance the German exporter, the importing nation (usually domestic companies) need to borrow money from banks (capital export). As a consequence, Germany builds up capital claims against those countries that run continuous current account deficits (or are a net-capital importer). Those capital claims do not weigh on the balance sheets of the German exporter but end up with German banks or insurance companies where German households store their savings. If this goes on long enough, the deficit country ends up over-indebted, defaults one way or the other, and the creditor banks receive a haircut, which could be a write-down of 50 percent or more of the obligation's face value. Those write-

downs must then be accompanied by a bank rescue in Germany since the banks could not survive such damage to their balance sheets. The bank rescue, in turn, must be financed by the taxpayer. In short, there is a redistribution of wealth from the general taxpayer toward the export industry, their owners and their employees. The distributional effects of such trade surpluses are rarely discussed, not even by the political left.

In Greece, for example, the unsustainability of the debt finally became so evident that even the rating agencies could not ignore it anymore. Once market participants realized that even with the harshest austerity measures Greece's creditworthiness would not save it, other countries started looking less attractive. As financial markets grow weary of eurozone sovereign bonds in general, contagion sets in and begins to affect countries like Spain, Italy, and France, whose deficits have gone up since the downturn but remain solvent. At some point they even start to doubt Austrian, German, and Dutch creditworthiness. In this view, German economic strength is not a force of stability but part of the underlying structural imbalances that created the crisis and propel it forward.

It is, therefore, not surprising that some find fault with creditor nations like Germany whose banks eagerly bought "Club Med" bonds when they seemed like risk-free assets, and now scream bloody murder over the lack of fiscal discipline. At the very least, according to the critics, Germany is complicit in the euro crisis by placing all of the blame on the debtors rather than taking creditors to task for lax risk management. Better for Germans to blame foreign politicians than domestic businessmen, just as politicians from southern Europe blame German businesses for their problems rather than their own irresponsible fiscal policies. Right now politics is all trumps in Europe.

The Adjustment Process

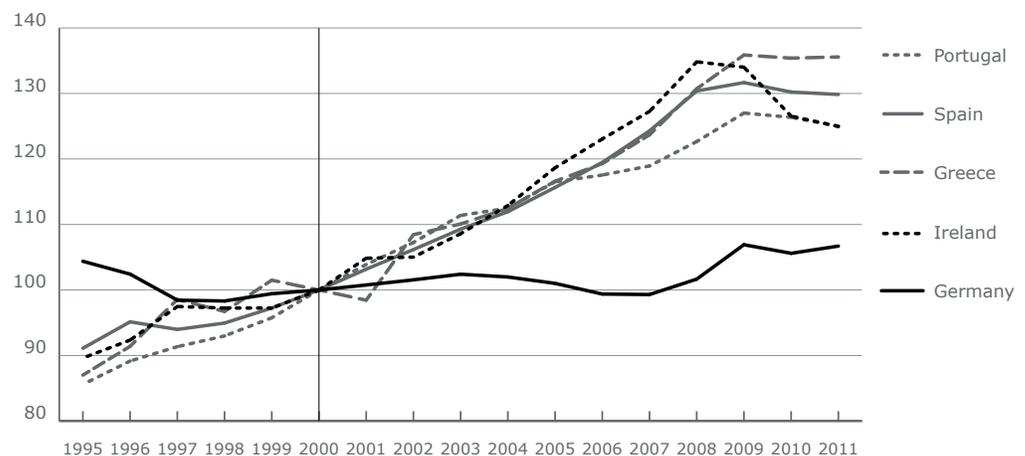
So far there has been little movement to unblock these imbalances. Without the ability of the deficit countries to depreciate their currencies relative to the surplus countries, in theory there are only three ways in which the deficit countries could return to a stable state in an economically heterogeneous currency area:

- They can keep wage increases relatively lower compared to the economically stronger regions.
- Their workforces can migrate to the stronger regions as they get laid off at home due to declining competitiveness.
- The faster growing regions can transfer money to the slower regions to support those who are no longer economically competitive.

If none of these three adjustment mechanisms—or any combination of those—works, either the faster or the slower growing region will leave the currency union at some point voluntarily or after some unforeseen crisis.

Since the beginning of the European Monetary Union, the countries with lower growth have kept up with high-growth regions when it comes to wage increases. Even though there are signs of increasing migration from Europe's south to the factories of Stuttgart and Munich, cultural differences and language barriers are still substantial, making it unlikely that the rebalancing will work through migration alone. It is unrealistic to expect the northern Europeans to show lasting solidarity with the south, when the northern Italians have proved unwilling to support their own citizens in the southern Mezzogiorno.

Figure 3: Nominal Unit Labor Costs: Total Economy
(Ratio of Compensation per Employee to Real GDP per Person Employed)



Source: AMECO

Looking at Germany as an example, Germany's southwestern region benefits from higher productivity and economic growth compared to the north and the east. Since all of Germany uses the same currency, we see a combination of mechanisms mentioned above. Wages in private industry increase a bit more in the southwest, East Germans migrated in large numbers to the West, and with the *Länderfinanzausgleich* (the financial equalization scheme) the states of Hesse, Baden-Württemberg, and Bavaria transfer billions every year to the north and east. That is why Germany and its sixteen diverse

Länder (states) continue to stay together as a currency union. Somewhat the same is true for the United States. Can we imagine the eurozone developing in that same direction?

Because of their experience with reunification, German policymakers would probably prefer a process by which migration drives the rebalancing process, and social transfers are limited and help even out the resulting instability. While visiting Madrid in February, Angela Merkel publicly called on educated and highly skilled Spaniards to consider

moving to Germany for work.¹¹

The Euro Crisis and European Integration

Since the end of the Second World War, German politicians have pursued Europeanization as the best way of anchoring Germany within the West and constraining German nationalism. The grand bargain after German reunification in 1990, which led to the introduction of the euro, was the latest chapter in this process of embedding Germany within a broader political and economic framework of European integration. The euro crisis has not ended this process as much as it has laid bare the vast shift in economic and political power that has accrued to Germany over the last twenty years. In a globalized world economy, Germany's endemic economic strengths have flourished, just as the weaknesses of the European periphery have grown more acute. Politically, however, Germany has been reluctant to openly wield power, partly due to its overwhelming economic strength, partly due to a tradition of consensus that eschews conflict. Yet the growing imbalances within the eurozone have made Germany into a regional hegemon of sorts, whose power and influence is "indispensable" to solving the crisis—to borrow a phrase from the former U.S. Secretary of State, Madeleine Albright.

A hegemon is rarely liked, but its leadership is often deemed necessary for durable solutions. Germany is negotiating this terrain carefully, as it is criticized for doing too much and too little at the same time. In November 2011 the Polish foreign minister Radoslaw Sikorski gave a speech in Berlin under the title "I fear Germany's power less than her inactivity."¹² But when Germany does act, others complain about the Germanization of Europe and its dominance. The French have long complained about the stolid inflexibility of German monetary policy but have also relied on German economic strength to hold down its own interest rates since the introduction of the euro. With its own deficits rising, however, French President Nicolas Sarkozy has recently admonished the French to become more like the Germans. It is in many ways ironic that Germans, who for the past decade have cultivated anti-American attitudes for the country's perceived overreach under George W. Bush, must now acknowledge what it means to be the largest and most powerful country in the region. Germany is

currently in the process of becoming to Europe what the U.S. is for the whole world: a preeminent power whose actions are monitored closely by the rest.

Germany has long been devoted to the European integration process, as have many other EU members. But the current crisis and the financial burden necessary to save the common currency may have a political price tag beyond the size of the rescue packages. In the short term it demonstrates what we have predicted in an earlier paper, that the adjustment process will have a political toll measured by political volatility, civil unrest, and early elections.¹³ Since the beginning of the euro crisis the following EU member states have seen a change of government more or less because of this crisis:

Slovenia: Regular election, December 2011

Italy: Technocratic government after public unrest, November 2011

Greece: Technocratic government after public unrest, November 2011

Spain: Early election, November 2011

Slovakia: Government lost vote of confidence to get European Financial Stability Facility (EFSF) passed, October 2011

Cyprus: Government stepped down after austerity measures, August 2011

Finland: Regular election, euro-sceptic party quadrupled its votes, April 2011

Ireland: Early election, February 2011

Portugal: Regular election, change of government due to unpopular austerity measures, June 2011

Portugal: Regular election, change of government due to unpopular austerity measures, June 2011

Netherlands: Regular election, conservative minority government tolerated by euro-sceptic party, June 2010

In the long run the fallout from the euro crisis might have an even larger impact on European history. Since the fall of the Berlin Wall, the integration process accelerated with the accession of central and eastern European countries. German Chancellor Helmut Kohl and French President François Mitterrand introduced a common currency long before the economic integration allowed for it, thereby hoping to force further integration steps on member countries. This attempt is now haunting Europe and it seems that Kohl and Mitterrand may have achieved the opposite, by dividing Europe to a point where steps toward disintegration are no longer out of the question.

The current crisis has caused many European publics to rethink the further transfer of political power to EU institutions or to enter a fiscal union in which government debt is socialized through eurobonds and one part of the EU constantly pays the over-consumption of the other. Enthusiasm for the European integration process among the EU population will wane in the foreseeable future.

Security Implications and the Transatlantic Effect

A eurozone collapse or partial collapse through the exit of some members of the European Monetary Union (EMU) is a very real possibility now, and has security implications for Europe and beyond. As Polish foreign minister Sikorski said in his speech: "The biggest threat to the security of Poland would be the collapse of the eurozone." This statement is mirrored by the *Foreign Policy* poll among global thinkers in which they state that, together with the Middle East conflict, economic decline is the biggest threat to world peace today.¹⁴

The euro crisis has security implications that affect transatlantic relations as well. European governments have been cutting defense budgets more radically since the crisis began, even in surplus countries like Germany, where finances for the Bundeswehr have been cut. This may make Europe even less capable of joining forces with the U.S. when it comes to burden-sharing or in providing for global or at least regional security. Combined with the debt crisis in the U.S., this means less willingness on the part of the

West to use its force to provide security or to defend its interests. And if the EU continues to muddle through the crisis, the lack of enthusiasm for the EU among domestic publics makes it unlikely that politicians will have the strength to call for an increased integration of military systems or coordinated security policies that will help ease the military burden of the United States.

For those who are hoping that Turkey will one day join the EU, the outcome of the crisis does offer some potential. If the crisis leads to a smaller euro area and a two-track Europe (those in the EU with the euro and those that are only part of the common economic area) there is little reason why Turkey should not join the outer ring. But there is also a growing list of reasons why Turkey might be better off with a "privileged partnership" rather than political integration with the EU, not least the country's own growing economic strength and regional clout.

But the biggest challenge facing transatlantic relations is the divergent attitudes and views about the economic imbalances in the global economy and the ways to solve them. Since Germany, like China, is a surplus nation, its policymakers love to criticize deficits and inflationary monetary policy as dangerous, irresponsible, and unsustainable. With unemployment at historic lows and continuously high export surpluses, this is understandable, as Germany does not want to see domestic household savings built up over the last ten years diminished through inflation or social transfers to southern Europe.

To many American observers, however, experiencing a 9 percent unemployment rate in a country with a weak social safety net and a public debt underwritten largely by China, this means a set of concerns diametrically opposed to Germany's. The U.S. is not only a debtor nation, but also one in control of its own currency; thus, monetizing part of its debt to keep investment flowing into the real economy makes prudent sense. From the U.S.' point of view, Germany is concerned with its own narrow interests as a surplus nation rather than the larger economic picture. Thus outside observers of Germany tend to argue that tying a Pan-European rescue package for the eurozone to fiscal austerity and deflation would dampen growth throughout the eurozone, as

Germany depends on external demand for its own growth. The continued uncertainty that hangs over the entire eurozone as Germany drags its feet only deepens fears of contagion and makes the ultimate bail-out bill larger. If Germany were to leave the euro or the economically weaker countries instead, it would not only cause chaos in the markets, but Germany's new currency would appreciate so fast that German exports would certainly take a big hit. Germany would be cutting off the nose of its neighbors to spite its own face.

From the vantage point of an Ordo-Liberal, on the other hand, one could argue that Germany would, in fact, gain from a smaller, yet economically stronger eurozone with a currency that appreciates against the dollar. This would help to balance Germany's trade account by making imports cheaper and exports more expensive. It would cool the German economy, which is in some parts of the labor market already at full employment, and at 3 percent inflation is clearly above the level Germans are comfortable with. In total, an appreciation would improve the terms of trade as well as the welfare of the German people by reducing import prices and stimulating further domestic demand for products from abroad. At the same time, the weaker economies of the current eurozone would benefit from the increase of price competitiveness thanks to the devaluation of their currency.

While the euro crisis rattles financial markets around the world, Germany's economic motor continues to hum above the din of fear about the world economy.¹⁵ If there is going to be some form of European bailout or fiscal union by the Germans, then it will be slow-moving, methodical, and on Germany's terms, with a correspondent commitment to the same kind of painful structural reforms in the periphery that Germany went through ten years ago.

Crisis was always part of the European integration process. However, now the roles are reversed. While Mitterand cajoled Kohl into a monetary union during the fast-moving events of German reunification that helped France and southern Europe, this time Angela Merkel is forcing Italy, France, and Spain to become more like the Germans and their well-ordered state. Time will ultimately tell whether this strategy succeeds or the eurozone collapses. The only thing for certain

is that Germany will be either praised or blamed for the result.

NOTES

- 1 Marc Raeff, *The Well-Ordered Police State: Social and Institutional Change Through Law in the Germanies and Russia: 1600-1800* (New Haven, 1983).
- 2 Christopher Clark, *Iron Kingdom: The Rise and Downfall of Prussia: 1600-1947* (Cambridge, MA, 2006).
- 3 Gerald Feldman, *The Great Disorder: Politics, Economics, and Society in the German Inflation: 1914-1924* (New York, 1993).
- 4 Adam Tooze, *Wages of Destruction: The Making and Breaking of the Nazi Economy* (New York, 2006).
- 5 A.J. Nichols, *Freedom with Responsibility: The Social Market Economy in Germany: 1918-1963* (Oxford, 1994).
- 6 Ibid.
- 7 Stephen Gross, "Why German Leaders are Reluctant to Pursue a US-Style Fiscal Stimulus," *History News Network*, 12 January 2009, <<http://hnn.us/articles/59445.html>>.
- 8 "Brown's VAT cut just Crass Keynesianism, says Germans," *The Guardian*, 11 December 2008, <<http://www.guardian.co.uk/world/2008/dec/11/germany-gordon-brown>>; "German Government 'Has to Step into the Breach'," *Spiegel Online International*, 24 November 2008, <<http://www.spiegel.de/international/germany/0,1518,592422,00.html>>.
- 9 "Schäuble: Austerity is essential to solve crisis," *The Independent*, 26 September 2011, <<http://www.independent.co.uk/news/business/news/sch228uble-austerity-is-essential-to-solve-crisis-2361054.html>>.
- 10 "The Wisdom of the Smart Crowd," *Foreign Policy Magazine*, December 2011, <http://www.foreignpolicy.com/articles/2011/11/28/the_wisdom_of_the_smart_crowd>.
- 11 "Spanische Fachkräfte in Deutschland-Angela Merkel hat gesagt 'Wir brauchen Euch' ," *Süddeutsche Zeitung*, 21 November 2011, <<http://www.sueddeutsche.de/karriere/spanische-fachkraefte-in-deutschland-angela-merkel-hat-gesagt-wir-brauchen-euch-1.1193210-2>>.
- 12 As published in *The Financial Times*, 28 November 2011, <<http://www.ft.com/intl/cms/s/0/b753cb42-19b3-11e1-ba5d-00144feabdc0.html>>.
- 13 Tim H. Stuchtey and S. Chase Gummer, "Global Economic Imbalances and International Security: Perils and Prospects," AICGS Issue Brief 39 (May 2011).
- 14 "The Wisdom of the Smart Crowd," *Foreign Policy Magazine*, December 2011, <http://www.foreignpolicy.com/articles/2011/11/28/the_wisdom_of_the_smart_crowd>.
- 15 "Crisis? What Crisis? ask the German consumers," *The Financial Times*, 30 November 2011, <<http://www.ft.com/cms/s/0/ed569f44-1b66-11e1-85f8-00144feabdc0.html>>.



DIFFERENT CIRCUMSTANCES
DEMAND DIFFERENT SOLUTIONS

02

DIFFERENT CIRCUMSTANCES DEMAND DIFFERENT SOLUTIONS: THE DIVERGING POLICY RESPONSES TO THE GREAT RECESSION IN THE UNITED STATES AND GERMANY

JACOB FUNK KIRKEGAARD

The United States and Germany were both very severely economically impacted by the Great Recession of 2008-09. Since both are also large industrialized nations and, as such, in many ways in the same boat, the frequent public political clashes between Washington and Berlin about the appropriate national government crisis response strategy witnessed since the economic recovery began ostensibly seem somewhat surprising. However, as this paper will make clear, several very fundamental differences exist in both the economic causes and effects of the Great Recession in the United States and Germany. Moreover, critical differences exist with respect to the strategic political challenges faced by American and German leaders after 2009. Given these deep-seated differences, the disparities in American and German economic policy responses to the Great Recession are actually unsurprising. They mirror the very different economic facts on the ground; the responses of nationally accountable sovereign governments to these facts; and do not likely signal a fundamental drift in the American-German relationship.

The Different Great Recessions in the United States and Germany: Growth and Fiscal Policy

Even after taking into consideration the recent revisions of U.S. GDP numbers, which saw the estimates for 2007-10 revised significantly downward and the Great Recession thus statistically deepened in the United States to a 3.5 percent contraction in 2009,¹ economic output in Germany declined appreciably

at more than 5.1 percent that year. Meanwhile, though, as illustrated in Figures 1A/B, the sectoral sources of these in both cases historically big declines in GDP were very different.

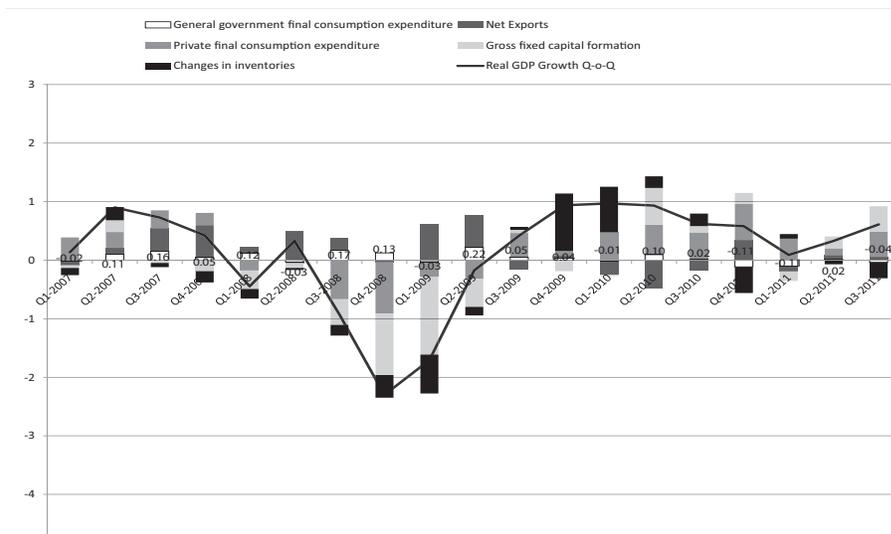
It is immediately clear how in the generally far more export-oriented German economy, overall GDP growth and sectoral contributions are considerably more volatile than in the larger continental-sized and more consumption-oriented United States. The U.S. economy fell into recession due to large protracted declines in private consumption and fixed capital formation (overwhelmingly from the collapse of residential construction), while Germany entered recession almost exclusively due to large drops in the growth contributions from net exports (i.e., gross German exports fell much faster than imports). With net exports, as imports dropped dramatically, actually contributing positively to U.S. growth during 2008-09, the sources of recession in the United States and Germany are near complete mirror images, reflecting the two countries' opposite position on each side of the global trade imbalances. Subsequently, that very different crisis mitigation policies were adopted by governments would be predictable.

Recalling the frequent clashes between the Obama administration and the German government about the need for more government fiscal stimulus to combat the crisis, it is critical to consider the full economic role of the government in this crisis. The government sector most directly affects the economy in two ways—automatic fiscal stabilizers and discretionary fiscal stimulus, whether in the form of new govern-

ment spending or government tax/revenue reductions. Unsurprisingly, as shown by the OECD² there is an inverse relationship between the scope of a country's automatic stabilizers (in place before the crisis) and its discretionary fiscal stimulus (implemented during the crisis). The OECD has estimated³

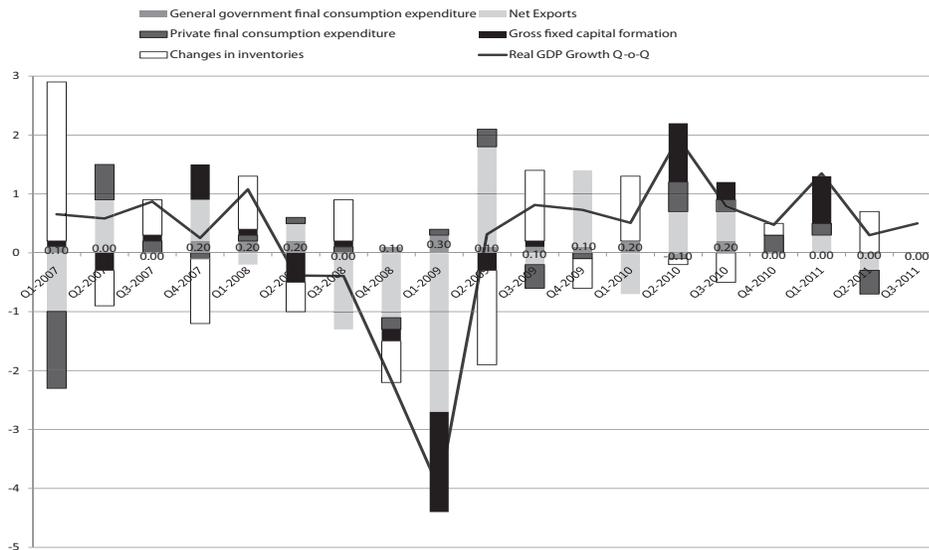
that in Germany, the automatic stabilizers are more powerful than the OECD average, while in the United States they are considerably less economically potent and pack only two-thirds of the economic effect of German automatic stabilizers.⁴

Figure 1A: Contributions to U.S. Real Quarterly GDP 2007-Present



Source: OECD

Figure 1B: Contributions to German Real Quarterly GDP 2007-Present



Source: OECD

With automatic stabilizers less powerful in the United States, a relatively heavier U.S. government reliance on fiscal stimulus as a share of the total fiscal reaction during 2008-09 is a given. With the crisis response emphasizing the discretionary fiscal element, the precise timing and composition of the U.S. stimulus package becomes an important issue. Automatic stabilizers by their nature generally have the advantages of both taking effect immediately as the economy begins to slow down, and generally rely on increased government spending to increase aggregate demand. The U.S. American Recovery and Reinvestment Act (ARRA) was signed into law in late February 2009, but according to the Congressional Budget Office (CBO) only reached its full economic impact about one year later in the first half of 2010.⁵

In addition, more than half of the economic stimulus included in ARRA came in the form of tax breaks to consumers and businesses, which in the dire U.S. economic circumstances in 2009-10 may not have provided the maximum stimulating economic effect. U.S. consumers and businesses who benefitted from a tax break in this period may frequently have decided to use this extra money to pay down debts, rather than go out and spend it. As a result, the so-called “output multiplier,” i.e., the cumulative effect of ARRA on GDP over several quarters, for large parts of the stimulus package was relatively low. The CBO estimates that the difference can be up to a factor of five, with direct government spending in the form of federal government purchases of goods and services generating \$2.50 of additional GDP for each dollar spent.⁶ This is compared to just \$.60 of additional GDP created for each dollar spent as part of ARRA on giving a one-year tax cut to higher income Americans. As a result, when looking for the actual beneficial economic effect of a fiscal stimulus package, it can be very misleading to simply look at the headline dollar or euro cost of the package in question.

A possibly superior metric for the role of the government sector in stimulating the economy during the Great Recession is the general government final consumption expenditure data in Figures 1A/B. Increases in government final consumption expenditure have among the highest output multipliers among the different types of fiscal stimulus, and might include increases originating in both automatic stabilizers and

discretionary stimulus measures. Especially in federal states like the United States and Germany, where large parts of government activities are located at the state and local level, it is critical to look at the combined economic effect of the full general government sector, including all layers of government. Focusing on just the federal government will be misleading, if stimulus enacted centrally is offset by spending cuts at the state and local level (a pattern recently seen in the United States).

Looking at Figures 1A/B, it is clear that by this metric of the relative scale of government stimulus, Germany had an overall expansion of general government demand creation at more than twice the level of the United States after the recession began in Q4 2007.⁷ On average, each quarter the German general government sector’s final consumption expenditure expansion has contributed 0.11 percentage points of GDP growth, compared to an average contribution of just 0.04 in the United States. It is moreover noteworthy that while in Germany only in a single quarter (Q2 2010) did the general government sector contribute negatively to GDP, this has repeatedly been the case in the United States since Q4 2010, as the declining stimulative effects of the federal government’s ARRA has been more than offset by accelerating cutbacks at the U.S. state and local level.

Consequently, the repeated calls from the Obama administration, referencing the economic crisis stimulus enacted by the United States itself, for Germany to “implement more stimuli” are factitious. There are within the G20 framework for “generating strong, sustainable and balanced global growth”⁸ numerous valid reasons for the United States to want Germany, a large surplus country, to do more to stimulate economic growth through domestic consumption and investment,⁹ but the relative scale of America’s own fiscal stimulus should not be one of them. Germany experienced a deeper contraction in GDP than the United States and aptly used the combined effects of its more effective automatic stabilizers and general government sector demand expansion to implement a bigger overall stimulus than enacted in the United States.

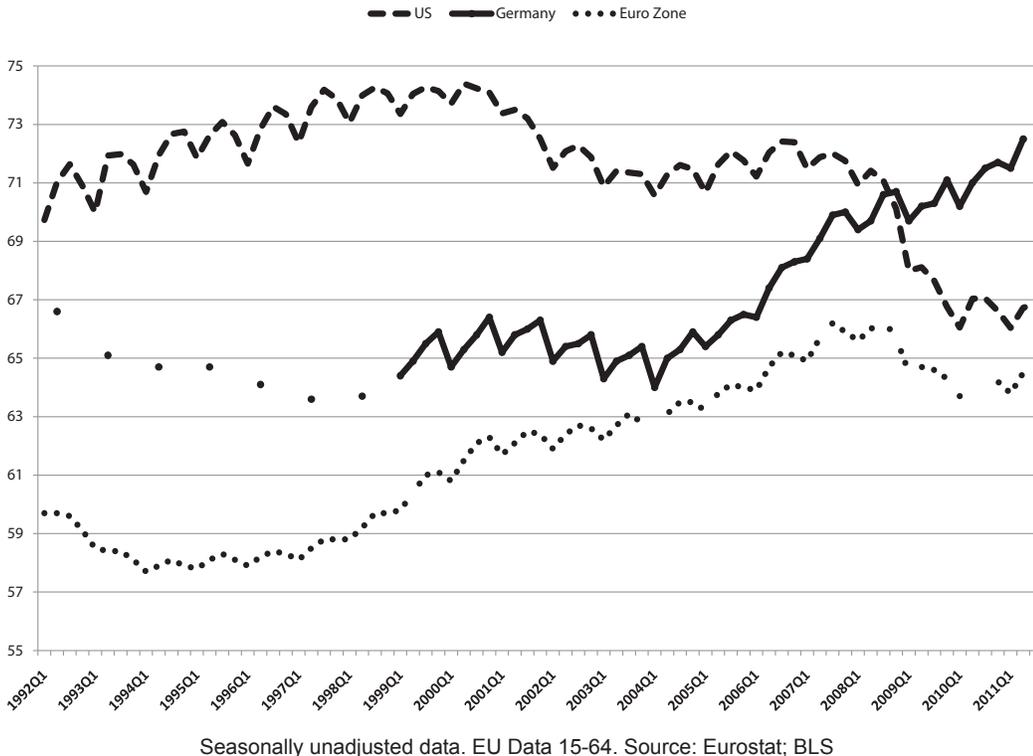
The Different Great Recessions in the United States and Germany: Labor Markets

The politically most important aspect of the Great Recession in any democratic country is probably the labor market performance and its impact on job creation. When thinking about this aspect of the Great Recession in U.S.-German context, a striking feature of the Great Recession is the pronounced “leveling effect” it has had on labor markets in the United States and Germany. Traditionally, its flexible and dynamic labor market has been among the biggest advantages the United States has enjoyed when compared with Germany, as well as Europe as a whole. Yet, even though Germany’s economic downturn was considerably deeper, it was disproportionately American jobs that disappeared with U.S. headline unemployment roughly doubling to between 9-10 percent throughout 2010. For the first time in

almost thirty years, U.S. unemployment has been considerably above the level in Germany for a sustained period of time.

As described by the OECD, various government-supported short-time work schemes, combined with reductions in overtime hours and other employer-initiated initiatives, meant that most of Germany’s recession-related labor input reduction was achieved through a reduction in Germans’ hours worked, rather than German jobs.¹⁰ In contrast, U.S. employers shed workers aggressively during the Great Recession, causing the traditional Okun’s law relationship between contractions in GDP and unemployment to break down.¹¹ As a result, the United States and Germany have experienced widely diverging productivity trends since 2008, with strong annual output per hour gains in the United States and substantial declines in Germany in 2009 and only a modest recovery in 2010.¹²

Figure 2: Employment Rates 16-64y, 1992 Q1 – 2011 Q3



By avoiding large increases in unemployment and the associated traditionally high risks of hysteresis effects (e.g., long-term unemployment), labor hoarding (i.e., the unwillingness of employers to lay off employees despite an economic slowdown) in Germany will have reduced the social costs of the Great Recession. However, at the same time, Germany could have been facing a potential jobless recovery, as the lower hours have been associated with a reduction in hourly productivity. This would be the outcome in Germany, if hours worked per employee and hourly productivity were to rise back to pre-crisis levels—a substantial increase in GDP without new jobs being created. Meanwhile, judged principally on the large number of job cuts and countercyclical productivity growth during the recession, the United States should have looked well poised for substantial job creation after the Great Recession. However, as illustrated in Figure 2, the opposite has occurred.

The working age employment/population ratio is the most intuitive measure for the ability of an economy to employ its working age population and controls for the changes in the overall population. As such it is a better indicator of the state of the labor market than the headline unemployment number, which is heavily influenced by entries and exits to and from the overall measured labor force and particularly the unemployed.¹³ Figure 2 shows the employment/population ratio from 1992 to the present in the United States, Germany, and the euro area.

It is immediately clear how during the 1990s and up to the mid-2000s, the United States enjoyed significantly higher employment rates than in Germany (or the euro area as a whole). However, that began to change gradually as early as the bursting of the internet bubble, from which the United States never fully regained all jobs, which is evident when controlling for population growth. Meanwhile in Germany, following the Hartz labor market reforms from 2003-05, employment rates began to rise strongly by the end of 2004.

The impact of the Great Recession on the U.S. labor market caused a dramatic drop in the total American employment rate to levels not seen since the early 1980s, well before the full entry of American women into the workforce. Or put another way, when control-

ling for population growth, every U.S. job created since Ronald Reagan's first term was destroyed during the Great Recession and no recovery has materialized, with total employment rates remaining stuck at catastrophically low levels.

The contrast with Germany is striking. Not only did Germany, unlike the United States, enter the Great Recession on the back of strong sustained gains in employment from the Hartz reforms, but the German labor market continued to increase job creation throughout the downturn and subsequent recovery to reach a historically high working age employment rate of 72.5 percent by Q2 2011. At the same time, as discussed above, reductions in Germans' hours worked accounted for a substantial part of the region's reduction in total labor input during the crisis. While this will tend to bias U.S.-German employment rate comparisons (as in Figure 1) in favor of Germany,¹⁴ the same general trend is found also when looking at the more comprehensive measure of hours worked/capita data. "Hours worked/capita" is a broad metric that has the advantage of incorporating both changes in employment and hours worked per employee, and as such takes account of the effects of both job losses, reductions in working time, and increases in the frequency of part-time work. The most recent data from the Conference Board¹⁵ suggests that U.S. hours worked per capita dropped by 63 hours annually from pre-crisis 2007 to just 772 hours per capita in 2010, a level last seen in 1983. Concurrently, hours worked/capita in Germany increased by 21 hours to 697 hours per capita in 2010. While thus aggregate labor input per capita remains higher in the U.S. economy than in Germany, this is much less true after the Great Recession than before, with per capita German labor input back at the 90 percent of U.S. levels seen around German unification and before the glorious decade of the 1990s for the American labor market.

While job creation therefore appropriately has remained the top priority for President Barack Obama (and, at least rhetorically, the U.S. Congress) recently and given rise to the administration's associated demands for more government stimulus in the United States and abroad, the extraordinary positive developments in the German labor market have not produced the same political impetus in Berlin. Indeed,

the strong labor market performance in Germany during the Great Recession and subsequent recovery will surely, following the sizable early and successful effect of German automatic stabilizers and increased government spending, have blunted any demands for Berlin “to urgently do more,” which could conceivably cause economic overheating in Germany. Most sovereign and democratic governments will respond urgently to stress signals from the politically crucial labor markets, and given the divergence in labor market signals sent to Washington and Berlin, it is unsurprising that their government policies have been quite different, too.

The Different Crisis Responses in the United States and Germany: Central Banks

As the euro area debt crisis has accelerated since the spring of 2010, increasingly the differences between the policy responses of the U.S. Federal Reserve and the European Central Bank (ECB) have risen to the top of the transatlantic media and political agenda. As the ECB is also Germany’s central bank, an increasing gap has, as the euro area crisis has deepened, opened up between the U.S. and German central bank crisis response.

Paraphrasing Donald Rumsfeld, the former U.S. defense secretary, you fight a financial crisis with the institutions you have, not the institutions you might wish you had at your disposal. And there is no doubt that Germany and the euro area entered the Great Recession woefully under-institutionalized with a common currency flying on just one motor—the European Central Bank (ECB)—but without the crucial unified fiscal entity that traditionally plays a critical role in combating large financial crises. More than anything, this crucial institutional difference between the United States, where the federal government is the principal fiscal agent and the Federal Reserve its established monetary policy partner, and Germany, which while increasingly powerful inside the euro area in this crisis, controls neither the fiscal policy of the euro area as a whole nor its central bank (the ECB), dictates the widening gap between U.S. and German central bank responses to this crisis.

While the ECB is often portrayed as being a larger

replica of the German Bundesbank, it is not controlled by the German government. In fact, as the ECB is the only truly federal institution in the EU with each euro area member having a single seat on the twenty-three person ECB Governing Council,¹⁶ the influence Berlin wields on the ECB is smaller than in other EU institutions. Moreover, even as the ECB and the German government right now clearly agree on the need for additional structural reforms and fiscal austerity in the euro area periphery, as well as stronger fiscal rules for the euro area as a whole, Frankfurt and Berlin have not seen eye to eye throughout this crisis. The ECB, for instance, vehemently opposed the German government’s ultimately successful demand for haircuts (e.g., a reduction in the value of the debt) for Greece’s private sector creditors. So, despite the fact that Berlin, in line with German political tradition and the German Constitution, will protect the complete political independence of the ECB, this does not mean that the German government controls the actions of the ECB in the same way that the U.S. Congress or British Parliament ultimately holds sway over their national central banks.

In the U.S. Federal Reserve Act, Section 31, Congress made it clear how “[t]he right to amend, alter, or repeal this Act is hereby expressly reserved.”¹⁷ In other words, the independence of the Federal Reserve can be undone by another Act of Congress. Although the Federal Reserve has, to date, conducted itself in an amicably independent manner in this crisis, the fact that the top four Congressional Republicans in September 2011 publicly called for the Federal Reserve Board to “resist further extraordinary intervention in the U.S. economy”¹⁸ would suggest that it might risk becoming subject to direct political pressure in the future and consequently will factor such potential pressure into some of its policy actions.

The independence of the ECB meanwhile is enshrined in the European Treaty’s Article 282, which explicitly dictates its independence and that “[European] Union institutions, bodies, offices and agencies and the governments of the Member States shall respect that independence.”¹⁹ As such its status cannot be altered by the actions of the German or any other individual European government.

Combined with its status as the only institution in the euro area with the capacity to act expeditiously and decisively in the European financial markets, this institutional independence has made the ECB a uniquely powerful and fully political actor in the aftermath of the Great Recession.

Initially, the ECB and the Federal Reserve responded quite similarly to the Great Recession by reducing interest rates dramatically at the end of 2008 and engaged in a series of interventions to prevent the collapse of the U.S., European, and global financial systems. With the crisis at the outset centered on the United States, the Federal Reserve intervened most dramatically by cutting short-term policy rates to zero, with an emergency bailout of AIG, and via a number of Federal Reserve programs designed to support the liquidity situation of key financial institutions, generally rendering improved conditions in financial markets.²⁰ In several of these emergency programs, the Federal Reserve entered into a close collaborative relationship with the American fiscal authorities in the form of the U.S. Treasury and the Troubled Asset Relief Program (TARP).

Most famously, perhaps, in November 2008, the Federal Reserve created the Term Asset-Backed Securities Loan Facility (TALF), under which the Federal Reserve Bank of New York (FRBNY) extended loans of up to \$200 billion with a term of up to five years to holders of eligible asset-backed securities.²¹ The FRBNY also got a commitment from the U.S. Treasury for a 10 percent “first loss credit protection” position up to \$20 billion, with any losses on pledged collateral above that level to be covered by the Federal Reserve. In other words, in agreeing to set up TALF, the Federal Reserve received an explicit credit guarantee by the U.S. taxpayer through the TARP, which enabled the central bank to extend loans to thousands of counterparties and take on more credit risk than would otherwise likely have been possible.

In the United States, there was at the outset of the crisis considerable concerns over the lack of individual institutions’ regulatory authority. This forced the Federal Reserve in September 2008, for instance, to provide AIG with an \$85 billion emergency credit line, despite not being AIG’s regulator or having any direct

involvement in the insurance industry. Similarly, early in the crisis before the approval of TARP, there was rapidly accelerating unease about the lack of Congressional approval for the commitment of public resources through the Federal Reserve to fight the crisis. In the end, however, following the tumultuous events surrounding first the defeat and then subsequent approval by Congress of the TARP program in October and November of 2008, the established political federal government institutions in the United States did respond in a manner that has enabled the Federal Reserve to increasingly hand over emergency crisis responsibility to other government entities under direct democratic control. The Federal Reserve was therefore able to act decisively early on in the crisis, knowing that if it did not Congress might revoke its independence, but even more importantly, that its principal task would be restricted to principally “act as an emergency crisis bridge,” until the other established branches of the U.S. government could take over the crisis management. Even purchasing large quantities of national government bonds as a crisis response should not be considered particularly politically risky; such purchases do not entail any financial redistribution between geographic entities, as the central bank itself is under the control of the issuing government.²²

In Germany and in the euro area as a whole, the institutional obstacles for the ECB to act in this crisis, however, have been far more daunting. The ECB has faced a much more complex problem than the Federal Reserve following the Great Recession. Given its independence, but with multiple individual governments inside the euro area and no established central fiscal authority, the ECB has to think first and foremost about the political incentives that its actions present to different elected euro area policymakers, unlike the Federal Reserve.

Traditionally, as seen in the United States in 2008-09, following a large economic shock the central bank is wise to apply the tactics of the “Powell Doctrine” to its emergency policy decisions, i.e., expeditiously in response to the crisis apply overwhelming economic force to restore shaken market confidence and thereby put in place “a bridge” until the government and fiscal authorities can formulate a longer-term policy response. This is a fairly well established and

in some ways mechanical “central bank crisis response function”—you come out with your monetary guns blazing and then sit back and pray that the politicians “do the right thing” afterward. Federal Reserve Chairman Ben Bernanke has repeatedly called on the U.S. Congress to follow up on the emergency crisis actions of the central bank and address the longer term fiscal problems facing the U.S. federal government.²³ However, as recently witnessed with the collapse of the efforts of the Congressional Joint Select Committee on Deficit Reduction,²⁴ so far elected U.S. policymakers have failed to act. This illustrates the “political moral hazard” early and aggressive central bank actions risk induce by implicitly “bailing out elected politicians” before they are compelled to take very unpopular decisions to fight the crisis in the longer term.

The ECB, however, does not have this luxury of merely adopting this tried and tested central bank crisis tactic within the fixed set of national institutions in its homeland. No euro area fiscal entity exists, and consequently the ECB cannot afford to think of its crisis role as merely a “bridge function” until the “euro area fiscal authorities take over.” Such a “euro area fiscal entity” is easily decades away, meaning if the ECB did so, and started its crisis response by “building a bridge” through overwhelming monetary stimulus, the ECB would quickly find out that it would have to ultimately fulfill that fiscal role itself permanently—it would be fighting the crisis by “building a bridge” only to the Frankfurt printing press.

Italian Prime Minister Silvio Berlusconi would still be in office had Rome earlier this year enjoyed the short-term economic benefits of the kind of large “bridging monetary stimulus” that everyone calls for in the form of pre-announced large ECB purchases of government bonds under market pressure. In the same way, should they get access to ECB financing, euro area politicians will never agree to hand over sufficient fiscal sovereignty to the euro area, and by “going big” the ECB would have undermined any chance for a permanent political resolution to the euro area’s crucial underlying under-institutionalization problem.

The simple political reality is that were they faced with, for example, fixed financing costs of no more than 5 percent, euro area politicians would never

make the required politically painful decisions. Unlike all other central banks, the ECB—as an independent political actor—faces the strategic challenge of ensuring that euro area politicians craft a lasting addition to the euro area political institutions out of this crisis. And while the ECB in this crisis is arguably the most powerful central bank in the world, Frankfurt cannot directly compel democratically elected European leaders to comply with this wish. Obviously not commanding any armies, the ECB is forced instead to strategically interact with its fellow political actors among euro area policymakers.

So far in this crisis, it seems fair to note that the ECB has been reasonably effective in its strategic bargaining with euro area governments. Out of the initial acute Greek crisis in May 2010 and the “grand bargain” then between the ECB (which agreed to set up the Securities Market Program (SMP)) and euro area governments,²⁵ came the €440 billion European Financial Stability Facility (EFSF), which proved quite sufficient to address the crisis need for a “euro area fiscal agent” when the problem was confined to Greece, Ireland, and Portugal. The EFSF, however, is woefully inadequate when Italy and Spain also face economic problems, countries clearly “too big to bailout” for the euro area. Consequently, as the ratification process of the “revised EFSF” during the fall of 2011 showed that there is no political will in the euro area to expand the bailout fund beyond €440 billion, the ECB is now faced with a new round of “strategic bargaining” with euro area governments in the run-up to the December 2011 EU Summit. The aim now is to ensure that not only do Spain and Italy implement the required structural reforms and fiscal consolidation to largely “bail themselves out,” but, even more importantly, that the half-built euro area institutional house is completed.

Unlike the Federal Reserve, which in line with its mandate and political circumstances has been doing its utmost to end the crisis in the U.S. as soon as possible, the ECB therefore has acted with restraint and been guided by the strategic need to use the pressure of panicking financial markets to try to coax euro area politicians into forceful actions. It is not trying to end the crisis right away, but to use it to present politicians with the right political incentives. It is, moreover, obvious that an ECB pre-commitment

to, for instance, guaranteeing a particular funding level for individual member states in the currency union would lead to unpalatable “political asymmetry” in the incentives presented to euro area politicians. Unlike Federal Reserve quantitative easing through which sizable amounts of national U.S. Treasury debt have been purchased, this is not an option available to the ECB, due to the absence of a eurobond debt instrument.²⁶ Instead, the ECB as a supra-national central bank is forced to intervene in euro area national bond markets and purchase what is the functional equivalent of U.S. state and local government bonds—something even the Federal Reserve has not done to date.²⁷ It is, however, easy to imagine that Ben Bernanke would be severely questioned in Washington and quite a few places, if he decided to buy the bonds of Illinois to help financially support the state government, before local politicians in the state capital of Springfield had committed to overhauling its state pension system or fix other structural defects (for example).

Viewed from the perspective of policymakers’ political incentives, it seems certain that were the ECB to replicate the large-scale pre-announced bond purchase actions of the Federal Reserve for an individual euro area member, it would inevitably lead to political demands for this to be extended to other members, too, and as such lead to a pan-euro area reduction of incentives for fiscal stability, structural reforms, and tighter economic integration. Consequently, factoring in the “double independence”²⁸ of the ECB, it will in all probability be a mistake to assume that in today’s crisis it will take any new large-scale measures reminiscent of the actions of the U.S. Federal Reserve, unless euro area governments commit to a further far-reaching political and economic integration of the euro area.

Conclusion

For more than sixty years, the United States and Germany have had a very close political and economic relationship. The Great Recession and the G20-led global political and economic struggle to contain its consequences and restart economic growth has, however, led to repeated political clashes about economic policy between the two traditional allies. These developments have occurred during and

probably been amplified by the increasing influence over economic policy in the entire euro area that Germany, as the currency union’s financial anchor, has acquired during the accelerating sovereign debt crisis in Europe since May 2010. Yet, it would be a mistake to interpret recent years’ increasingly frequent clashes over economic policy between Washington and Berlin as reflecting a general undermining of the old transatlantic alliance.

Instead, as this essay has clearly illustrated, while both the United States and Germany were deeply negatively affected by the Great Recession, its economic effects nonetheless were very different in the two countries. Especially trends in the politically imperative national labor markets have been highly divergent, as the United States remains mired in a historical jobs recession and Germany experiences its highest employment rate ever. In addition, there are vastly different political and institutional situations in which the Federal Reserve and the ECB have been called upon to address the economic effects of the Great Recession. Such profound differences matter for policymakers, and that U.S. and German economic policies have therefore diverged since 2008 is not only unsurprising, but probably dictated by these vast differences in economic circumstances.

What has happened between the United States and Germany in terms of economic policy since the Great Recession began is essentially what we would expect from democratically accountable leaders. When the economic circumstances again begin to converge—which may take a while—so, too, will the political responses.

NOTES

References used for figures:

Bureau of Labor Statistics Current Population Survey (CPS) Online Database. Available at <http://www.bls.gov/cps/#data>.

Eurostat Quarterly LFS database, available at http://epp.eurostat.ec.europa.eu/portal/page/portal/statistics/search_data_base.

1 Bureau of Economic Analysis, *Annual Revision of National Income and Product Accounts*, Washington, DC, 2011, <http://www.bea.gov/scb/pdf/2011/08%20August/0811_nipa_annual_article.pdf>.

2 OECD, *OECD Interim Economic Outlook Chapter 3, The Effectiveness and Scope of Fiscal Stimulus*, Paris, 2009, <<http://www.oecd.org/dataoecd/3/62/42421337.pdf>>.

3 N. Girouard and C. André, "Measuring Cyclically adjusted Budget Balances for OECD Countries," *OECD Economics Department Working Papers*, No. 434 (2005).

4 In Germany, the automatic change in the fiscal balance (as a percent of GDP) due to a 1 percentage point change in GDP is 0.51, whereas in the United States it is only 0.34. The OECD average is 0.44 and euro area average 0.48.

5 Congressional Budget Office, *Estimated Impact of the American Recovery and Reinvestment Act on Employment and Economic Output from July 2011 Through September 2011*, Washington, DC, 2011, <<http://www.cbo.gov/ftpdocs/125xx/doc12564/11-22-ARRA.pdf>>.

6 Ibid., table 2.

7 This refers to the official U.S. business cycle dates determined by NBER, which sets the beginning of the U.S. recession in December/Q4 2007. See <http://www.nber.org/cycles.html>. As can be seen in Figure 1A, the recorded decline in quarterly U.S. GDP began only in Q1 2008. Germany does not have an equivalent to the NBER business cycle dating, and as such the German recession can be said to have begun only with the first reported decline in GDP in Q2 2008.

8 This goal has been repeated by the G20 leaders at the summits since the beginning of the Great Recession in 2008. See for instance the Pittsburgh Summit Leaders' Statement from September 2009, <http://www.g20.org/Documents/pittsburgh_summit_leaders_statement_250909.pdf>.

9 See G20, *The Cannes Action Plan for Growth and Jobs* (2011), <<http://www.g20.org/Documents2011/11/Cannes%20Action%20plan%204%20November%202011.pdf>>.

10 OECD, *OECD Employment Outlook 2010*, Paris, 2010.

11 See M. Daly and Hobijn, "Okun's Law and the Unemployment Surprise of 2009," *FRBSF Economic Letter*, 8 March 2010, <<http://www.frbsf.org/publications/economics/letter/2010/el2010-07.html>> and L.H. Summers, "Rescuing and Rebuilding the U.S. Economy: A Progress Report." Prepared remarks at an event held at the Peterson Institute for International Economics, 17 July 2009, <<http://www.iie.com/publications/papers/paper.cfm?ResearchID=1264>>.

12 OECD StatExtracts, <<http://stats.oecd.org/Index.aspx?DatasetCode=PDYGTH>>.

13 Unemployed people that stop looking for work consequently drop out of the labor force and hence reduce measured unemployment levels are a particular concern.

14 This type of employment data is not available as "full-time-equivalent" (FTE) data.

15 Data from "The Conference Board Total Economy Database," January 2011, <<http://www.conference-board.org/data/economydatabase>>.

16 The ECB's Governing Council consists of the ECB's six person Executive Board and the governors of the 17 national central banks of the euro area. Traditionally, Germany and the other large euro area members have at least one national representative on the ECB Executive Board. See <<http://www.ecb.int/ecb/orga/decisions/govc/html/index.en.html>>.

17 Federal Reserve Act, available at

<<http://www.federalreserve.gov/aboutthefed/section31.htm>>.

18 Letter to Federal Reserve Board Chairman Ben Bernanke from Sen. Mitch McConnell, Rep. John Boehner, Sen. Jon Kyl, and Rep. Eric Cantor, 20 September 2011. Available at <<http://blogs.wsj.com/economics/2011/09/20/full-text-republicans-letter-to-bernanke-questioning-more-fed-action/>>.

19 Consolidated versions of the Treaty on European Union and the Treaty on the Functioning of the European Union, available at <http://www.ecb.int/ecb/legal/pdf/xfac08115enc_002.pdf>.

20 These programs have at various times included the Money Market Investor Funding Facility (MMIFF), the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF), the Commercial Paper Funding Facility (CPFF), the Primary Dealer Credit Facility (PDCF), the Term Securities Lending Facility (TSLF), and the Term Auction Facility (TAF). Many of these emergency programs have subsequently been closed down again as market conditions have improved.

21 Eligible securities must have received two AAA ratings from the major rating agencies, and none of the major rating agencies can have rated the security below AAA or placed the security on watch for a downgrade. See U.S. Treasury, *Troubled Asset Relief Program: Two Year Retrospective* (Washington, DC: U.S. Treasury, 2010), 35

22 The issue of whether large purchases of government bonds is inherently inflationary depends on the economic circumstances in which such purchases take place, the scope of purchases, and the responses of other government entities to such purchases. If such purchases take place at a time of zero nominal interest rates (e.g., a liquidity trap) and a sizable output gap, are relatively limited as a share of GDP and are complemented with appropriate fiscal and economic reform measures from elected officials, central bank purchases of government bonds can be an appropriate, indeed critically needed, policy intervention without any inflationary impact on the short or long run.

23 See for instance Ben Bernanke's testimony before the Joint Economic Committee on 4 October 2011 in which the final paragraph of the prepared remarks reads as follows: "Monetary policy can be a powerful tool, but it is not a panacea for the problems currently faced by the U.S. economy. Fostering healthy growth and job creation is a shared responsibility of all economic policymakers, in close cooperation with the private sector. Fiscal policy is of critical importance, as I have noted today, but a wide range of other policies—pertaining to labor markets, housing, trade, taxation, and regulation, for example—also have important roles to play. For our part, we at the Federal Reserve will continue to work to help create an environment that provides the greatest possible economic opportunity for all Americans." Ben Bernanke, Economic Outlook and Recent Monetary Policy Actions. Testimony Before the Joint Economic Committee, U.S. Congress, Washington, DC, 4 October 2011. Available at <<http://www.federalreserve.gov/newsevents/testimony/bernanke20111004a.htm>>.

24 See details of the work of the so-called "Super Committee" at <<http://www.deficitreduction.gov/public/>>.

25 For details, see J.F. Kirkegaard, (2010). "In Defense of Europe's Grand Bargain," *Peterson Institute For International Economics Policy Brief* 10-14 (Washington, DC, 2010), <<http://www.piie.com/publications/interstitial.cfm?ResearchID=1595>>.

26 The ECB has to my knowledge not purchased any "proxy eurobonds" issued by the European Commission, the European Investment Bank, or the EFSF.

27 There was, however, some speculation that the Federal Reserve in late 2010 might purchase Californian bonds and Ben Bernanke of course in his famous 2002 speech to the National Economist Club explicitly stated that the Federal Reserve has the authority to buy state and local government debt. See <http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20021121/default.htm>. Due to the unitary character of the United Kingdom, neither Wales nor Scotland has legal authority to issue their own bonds, so the BoE to date does not have this option. This may change in the future though as political devolution continues in the U.S. See <<http://www.bbc.co.uk/news/uk-scotland-13756612>>.

28 The ECB is both independent through the EU Treaty, a legal document more difficult to change than any national euro area constitution, and has the independence of being a supra-national central bank with multiple government constituencies.

AICGS

1755 Massachusetts Ave., NW
Suite 700
Washington, D.C. 20036 – USA
T: (+1-202) 332-9312
F: (+1-202) 265-9531
E: info@aicgs.org
www.aicgs.org

AMERICAN INSTITUTE
FOR CONTEMPORARY
GERMAN STUDIES

THE JOHNS HOPKINS UNIVERSITY

Located in Washington, D.C., the American Institute for Contemporary German Studies is an independent, non-profit public policy organization that works in Germany and the United States to address current and emerging policy challenges. Founded in 1983, the Institute is affiliated with The Johns Hopkins University. The Institute is governed by its own Board of Trustees, which includes prominent German and American leaders from the business, policy, and academic communities.

Building Knowledge, Insights, and Networks for German-American Relations