BY KLAUS C. ENGELEN

Germany Fires *Back*

And who does Adam Posen think he is, anyway?

For Germany's informed public—the political establishment, the media, and the business world—outside views carry a lot of weight, particularly if they are expressed by a leading international expert on Germany and Europe. Adam S. Posen is such an expert. He is deputy director and senior fellow with the Peterson Institute for International Economics, and *TIE*'s Associate Editor and Chief Economic Commentator.

Returning from summer vacation, Berlin's political community and Frankfurt's business world could hardly avoid getting Posen's views on important current issues.

As losses on complex financial instruments backed by subprime mortgages in the U.S. housing market were sending shockwaves through financial markets around the world, German banks with a public-sector domestic orientation began to reel. IKB Deutsche Industriebank, the specialist lender to small- and medium-sized firms, and Sachsen LB, the Landesbank of the state of Saxony, were caught with huge exposures in the U.S. subprime mortgage market. They had to be rescued by large liquidity infusions ordered by the banking supervisors. In interviews with the German press, Posen tried to put the possible damage from the subprime mortgage crisis to Europe in perspective. On September 6, 2007, in the *Börsen-Zeitung,* he predicted: "In a few weeks the stormy seas will be calmer again." He also reminded investors in Germany and other parts of the world that, "by then speculators will have gotten rid of their financial poison and will have made their money."

On August 26, 2007, in the mass circulation *Welt am Sonntag,* Posen tried to calm fears in the hubbub of the current financial crisis by pointing to the central

Klaus Engelen is a contributing editor for both Handelsblatt *and* TIE.

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888 16th Street, N.W.
Suite 740
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Taking The German Recovery *Less Seriously*

A counterintuitive view.

By Adam S. Posen

Trade vs. Growth

Germany's famed six economic institutes have now started competing over who can raise their economic forecasts the most, instead of who can be the gloomiest.

Adam S. Posen *is deputy director of the Peterson Institute for International Economics in Washington, D.C., where he has been a senior fellow since 1997. The Institute will publish his new book,* Reform and Growth in a Rich Country: Germany, *in early 2008. Dr. Posen also serves as* TIE*'s Associate Editor and Chief Economic Commentator.*

"In the summer issue of *TIE,* Posen lived up to his reputation: that he is good at taking away the champagne glass and spoiling the party…"

"Posen is going beyond the 'reform laundry list' of the major political parties and is becoming a pain in the neck."

bankers as still-reliable guardians of financial stability and explaining why the eurozone's lead central banker "is gaining fans through his activism, while the Federal Reserve's chairman is showing restraint—contrary to stereotypes and to the two institutions' own self-proclaimed orientations." The reason: The responses of European Central Bank President Jean-Claude Trichet and Federal Reserve Chairman Ben S. Bernanke to the recent liquidity crisis were different. Posen's message: "The financial—and particularly the banking system—is still more vulnerable in continental Europe than in the United States, and the transmission of problems in the banking system to the real economy is greater in the eurozone than in the United States. Thus, the differences in central bank responses across the Atlantic are not caused by a difference in style or ideology."

But before, with his piece "Taking the German Recovery Less Seriously" in the summer issue of *TIE,* Posen lived up to his reputation that he is good at taking away the champagne glass and spoiling the party.

His provocative message: "While the benefits of German economic recovery are real and welcome, no one should attribute much lasting meaning to today's German economic recovery." He derides Germany's famed six economic institutes who "have now started competing over who can raise their economic forecasts the most, instead of who can be the gloomiest." He recalls "that it seems a far cry from just two years ago, when books about Germany's economic malaise or decline or even crisis dominated the country's bestseller lists." He introduces the "Dirk Nowitzki fallacy" into modern economic theory. If people were to say, "Because Dirk Nowitzki of the Dallas Mavericks won the NBA's Most Valuable Player award, all German people are really good basketball players," we would dismiss that as silly, he explains. Germany's preoccupation with remaining the world export champion is misleading, goes his thesis. "Because there are a couple of little machine tool companies in Baden-Württemberg that happen to make some exports to China, advocates of the Mittelstand argue everything is OK. But this doesn't really mean anything about the corporate sector generally and there is no correlation between how much a developed economy exports over the long term and how fast it grows."

Posen questions the long-term economic growth potential of Europe's largest economy for several rea-

Take That!

"**Adam Posen** is wrong, but in an intelligent way," says **Gustav Horn,** director of the Macroeconomic Policy Institute (IMK) at the Hans-Böckler Foundation.

sons. German real potential growth has not risen and is still only 1.5 percent or less per capita. "It is failures in the German private sector allocation of and returns to capital that are at work and that are still waiting to be addressed by increased market discipline or enforced liberalization." And he argues: "As soon as the economy started to pick up, German companies had to add a lot of workers to generate a small increase in production, which is the very opposite of productivity growth."

"No! You are wrong," say most German economists.

"Contrary to Posen's observation, I see Germany's economic growth dynamics on a fundamentally sound footing," says Jens Weidmann, who heads the economics department in the German Chancellery. "The export sector is the classical leg of our highly innovative and competitive economy. Last year, for the fourth consecutive turn, Germany was the world's export champion and the only industrialized country able to increase its global market share in the face of growing competition from emerging market economies. Behind this achievement are not only—as Posen argues—a few 'Mittelständler from Baden-Würtemberg.' In our country, no less than 8.3 million jobs depend on exports, and exports now make up 45 percent of GDP. In the meantime, business investment has become the second engine pushing economic activity. Last year, business investment expanded 8.3 percent, a level not seen since 2000. Also during the first half of 2007, companies kept their investment levels high. With labor productivity increasing and real unit labor costs decreasing, Germany was able to further strengthen its international competitiveness."

Chancellor Angela Merkel's chief economic advisor continues: "Our upturn stands on firm ground. This is due to companies that have restructured their operations and also due to the collective bargaining partners agreeing to modest wage settlements. Structural reform policies have helped to improve the growth conditions. As the Kiel Institute for World Economics points out, Germany's economic growth potential was improved by labor market reforms and by decreasing tax and supplemental wage costs. Most business indicators signal that in spite of a minor slowing, the German economy is still on a dynamic growth path. The fallout from the U.S. financial market turbulence has increased the risks for the world economy. But at this time, I do not see a negative impact on the robust economic growth level in Germany."

"Adam Posen is wrong, but in an intelligent way," says Gustav Horn, director of the Macroeconomic Policy Institute (IMK) at the Hans-Böckler Foundation. "He correctly perceives that an export boom is not the solution to German growth problems, but he fails to notice that lackluster domestic demand is the result of excessive wage constraint rather than lack of competition on goods and capital markets. This wage restraint has led to declining real incomes of private households. As a consequence, those firms particularly focused on the German domestic market fell under heavy pressure. Therefore competition, especially in the retailing sector, is very tough and firms have had to leave the market at record levels. There were no public banks in place to subsidize these."

Addressing the spectacular implications of public-sector banks in the current financial crisis, Horn tries to be diplomatic. "The serious problem with public banks is—as the current crisis shows—that some of them seem to engage in very risky businesses such as the U.S. subprime market. One could reasonably ask why a German public-sector bank takes these risks in foreign markets. The answer is they want to behave like any other bank, but at the expense of taxpayer's money." Where Horn skirts the issue is how these public-sector banks failed to work on a business model that provided them with a good stream of sustained earnings. Horn sees the solution in stricter regulatory control. This would save taxpayers money, "but certainly not change the German growth record." Says

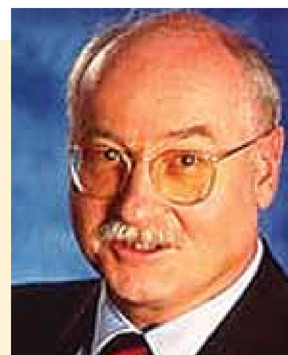
Posen is questioning the long-term economic growth potential of Europe's largest economy.

Horn: "In sum, Adam Posen is moving in the right direction but on the wrong track."

Take This!

"I like **Adam Posen's** papers because in most cases they are contrarian and offer new insights. Germany needs such creative thinkers who look at it from the outside. This time, however, Posen's paper unfortunately is neither contrarian (he goes along with the mainstream negative assessment of Germany's long-term economic prospects) nor does it give new, or better yet correct, insights."

—M. Hüfner



Martin Hüfner

A high official in the Berlin finance ministry, who speaks on condition of anonymity, sums up his reaction to Posen's thesis: "His arguments are not new—also not his more-or-less critical appraisal of the current state of German economic and financial policies. What stands out is that the thesis he advances is not supported by empirical data and by examples. Instead, he paints the picture of a country that is unwilling to reform. Certainly, there have been exaggerations like talking about a 'new German economic miracle.' And there is no agreement among the politicians how much the social and labor market reforms that were proposed and carried through in recent years have contributed to the economic upswing. Some observers talk about a rather typical cyclical German upturn in economic activity driven largely by a high level of global export demand that is spreading to more investment at the company level. Due to political austerity measures like cutting pensions and increasing value-added taxes, consumers have not been reached by the economic improvements, a development that potentially could endanger the present economic upturn and dampen economic prospects."

Even some of the leading economists working for big U.S. investment houses are not reacting kindly to Posen's "counter-intuitive view." When we asked Dirk Schumacher, the Goldman Sachs economist covering Germany, to give his view on Posen's question marks behind Germany's economic recovery, he replied with a very short statement: "The main argument of Posen seems to be that the allocation of capital and the returns on capital are unsatisfactory in Germany. This is clearly at odds with the data. In fact, the return on capital has increased significantly in Germany over the last couple of years. The rise in the return on capital is the consequence of a fundamental change of the German financial system from a predominately bank-based system to a more capital-market based system. This improved rate of return has led a sharp rise in investment spending over the last two years and also a strong rise in employment."

"In sum, Adam Posen is moving in the right direction but on the wrong track."

Most major economists from the major banks would echo Schumacher's upbeat assessment. Michael Heise, chief economist of Allianz AG and its subsidiary Dresdner Bank, welcomes the fact that "economists refuse to get too excited about the German economic recovery and do not allow themselves to be blinded by rip-roaring export growth." And he admits: "It is certainly correct that Germany still has homework to do, for example improving its education and training systems, and boosting the return on human and physical capital. But nonetheless, Adam Posen's analysis is misleading on a number of counts. For example, there is no mention of the fifteen-year downscaling of the construction industry following the unification boom, no mention of the self-imposed consolidation measures that put a brake on the economy for so long, no mention of the widespread corporate restructuring efforts after the artificial boom of the late 1990s and the very major changes in the relationship between employers and employees at the corporate level, and only a brief side remark concerning the labor market reforms which have significantly reduced unemployment allowances and fundamentally altered the incentive structure. These developments were all elements of the protracted consolidation and recovery process of the German economy."

Heise accuses Posen of "brushing over this, and therefore overlooking some trends in the recent data. For one, labor productivity increased in 2006 by more than 2 percent, despite the growth in employment; this is not 'the very opposite of productivity growth,' but a higher rate

If the state of the German economy is as bad as Posen assumes, why is so much foreign capital flowing into the German market?

than, for example, in the United States. On top of that, Posen seems to overlook the fact that a healthy investment recovery is underway, especially in the area of machinery and equipment. It is true that the investment ratio is still too low, but this plainly stems from the corporate consolidation and the disinvestment undertaken in recent years. Corporate Germany has been changing at a very fast rate, and this should also have found some mention. Ultimately, the conclusion that there have been no major structural changes and the rate of potential output is as low as ever is misleading. Given plausible trends in investment, labor input, and productivity, potential output growth is probably already back at 2 percent and should continue to edge up in the coming years. That said, in a rapidly changing world, it is always right to call for further reforms. In Germany that means reforms of the tax system, some sectors of social security, further labor market reforms, and intensified efforts to improve education and training."

In addition, Andreas Rees, chief German economist of HVB/UniCredit, supports the views of Schumacher and Heise on key points. "I do not believe that the German corporate sector is not efficient and that there is the need of a 'real structural reform agenda.' Major reforms already took place in the previous years. German unit labor costs, for example, remained stable since the start of EMU in 1999. In the rest of the eurozone, unit labor costs rose by about 20 percent. As a matter of fact, German companies did their homework in recent years, explaining why higher productivity is not a one-off effect."

Rees also sees Germany's role as export champion as more or less as the flip side of Germany's strong industrial performance: "Investment in machinery and equipment has not been lagging behind during the recent upswing in Germany. In contrast, investment activity rose 27 percent since hitting its trough at the beginning of 2004. Exports increased 32 percent. Hence, there is absolutely no decoupling between exports and investment this time. In contrast, by German standards, the gap between the two figures is rather small." And he reminds Posen that "higher wages in Germany are not the trigger for the upswing via higher domestic demand, as wages started increasing markedly only in the spring of 2007. Instead, wage moderation in the previous years in combination with strong exports and investment activity led to job creation."

Martin Hüfner, who for many years was chief economist of HypoVereinsbank and now writes a weekly economic outlook letter and is publishing another book, knows Posen from the time the young U.S. economist appeared on the scene. "I like Adam Posen's papers because in most cases they are contrarian and offer new insights. Germany needs such creative thinkers who look at it from the outside. This time, however, Posen's paper unfortunately is neither contrarian (he goes along with the mainstream negative assessment of Germany's long-term economic prospects), nor does it give new, or better yet correct, insights."

Then Hüfner takes on the expert on Germany in a broadside of counterpoints.

First, Posen deplores the low growth of per capita income in Germany (1.4 percent over the period 1991 to 2005). Indeed, we all want to have more growth in this country. But in the international context, the Federal Republic does not fare too bad. U.S. GDP per capita, for example, grew over the same period by a mere 1.9 percent, less than half a percentage point more. And that despite the boom of the new economy in the United States in the 1990s. Germany, on the other hand, suffered in this period from the burdens of the reunification, the overvalued deutschemark, and the introduction of the euro. Adjusted for these special factors, the difference in the growth rates between these two countries would even be smaller, perhaps a quarter of a percentage point. This is less than one would expect taking into account the traditional dynamics of the United States and the bureaucratic and inflexible image of the Germans. In any case, it is not enough to be so pessimistic on the German economy.

Also, Posen complains that the "real structural reform agenda, which is about increasing efficiency in the German corporate and financial sector, remains to be tackled." This is true only in respect to economic policy reforms, not individual companies. Never before has Germany had so many reforms. No other country had so many reforms in the last several years. But these reforms were not (or only to a small extent) the economic policy reforms for which everybody had called, but reforms on the level of companies, of labor market participants, and of the financing structures.

Look at the huge restructuring efforts in German companies, says Hüfner, both the Mittelstand and the big ones. Today's firms such as Bayer, BASF, Siemens, Allianz, Thyssen, or Deutsche Bank have little in common with what they were five years ago. Look at declining wages (nominal and real wages) in the companies. Look at the increasing working hours, or the increasing pension age (from 59 to 61). Look at the rising importance of private equity funds in the financing of German companies (the famous "locusts").

Another point is that the old Germany, Inc., no longer exists. Banks have nearly completely reduced their participation in industry. Insurers are following suit. Corporate governance, formerly unknown in Germany, is now becoming a common practice. However, much can still be done, especially in the finance sector.

This is not technical progress in the usual sense of the word, but an increase in what economist Harvey Leibenstein called X-efficiency, which, it is true, is difficult to measure. Many of these changes were induced by foreign capital inflows, especially the inflows of private equity funds. As a public example, look at the influence a fund such as Blackstone is exerting on Deutsche Telekom (though Blackstone only has a stake of less than 5 percent).

In addition, Hüfner argues that it is one of the twists of history that it was the German capital market, as small and unimportant as it is, that triggered a great deal of the reforms in German industry.

Posen, Hüfner notes, refers to low productivity gains in Germany as justification for his case. It is true that German productivity growth presently is surprisingly low for a period of recovery. That has specific reasons, however. One is that the cost of labor has declined relative to the cost of capital, resulting in a substitution of capital by labor. Another is that gains in X-efficiency usually take some time before they show up in macroeconomic productivity numbers. (The same phenomenon could be observed when personal computers and the Internet led to huge productivity gains which needed a couple of years before they showed up in macroeconomic numbers). Finally, the cyclical recovery came as a surprise to most companies, so they could not draw on labor reserves accumulated in the preceding years of stagnation (as is usually the case in the cycle). There were simply no accumulated labor reserves.

Hüfner points out that if the state of the German economy is as bad as Posen assumes, why is so much foreign capital flowing into the German market? Do foreign investors not know what they are doing and where they are investing? In fact, the German stock market index DAX has far outperformed the Dow Jones Industrial Average over the past two years. Foreign direct investments in German companies amount to €30 billion per year. The big international private equity funds have discovered the German Mittelstand and made it a preferred place to invest.

Hüfner concludes that Posen had better take the German recovery more seriously. This is not just a cyclical improvement, but a structural change. It will not be temporary, but permanent. The sick man of Europe is going to be the new growth engine of Europe. Nevertheless, he agrees with Posen's mantra that the German Grand Coalition should not allow recent successes to be used as an excuse to leave the country's reform agenda unaddressed. We all know that for a lasting recovery it is not enough to have reforms on the company level. Appropriate functioning of the markets is also needed. In addition, it is obvious that more reforms in the corporate and financial sectors are required. Germany has yet to reach the level that should be reached, but a good start has been made.

"Adam Posen is certainly right in one important respect—Germany's educational system is deplorable."

Dieter Wermuth, who for many years was Citibank's chief economist in Germany, considers Posen's piece a "polemic." But he admits that "Adam Posen is certainly right in one important respect—Germany's educational system is deplorable and potentially the reason why medium-term GDP growth will disappoint. The primary school system is a catastrophe and much of the university system as well. The political leadership has not yet understood that the future of the economy is crucially dependent on the quality of human capital inputs. Reform policies for Germany must be redirected in order to achieve a turn-around in the educational system, including using English in most advanced courses, as is the rule in Scandinavian countries, Holland, or Switzerland. It should also be made much easier to grant tenured positions to non-Germans and to attract foreign graduate students. Conservative politicians continue to deny that Germany's future depends on foreigners."

Wermuth comes up with another positive development. "But it must also be said that commodity-poor Germany is still at the cutting edge of technology—contrary to what one would expect after reading Posen's piece. One indication is the number of patents. At the European Patent Office, Germans were granted 14,274 patents last year. This translates into 174 patents per one million inhabitants. The comparable numbers for France were 74, for the United Kingdom 38, for Japan 94, and for the United States 49. If you look at time-series data, it is clear that Germany is doing exceedingly well year after year in this key statistic, a proxy for a country's technical ingenuity. Not only that, the share of Germany's capital goods exports in total world trade in those goods has continued to rise in recent years, unlike that of Japan or the United States—and this in spite of the strong appreciation of the euro. Capital goods are typically not produced by intellectual simpletons. Looking at these numbers, it is hard to share Posen's sense of gloom. Germany is doing rather well in human-capital-intensive and high-value-added products, thank you very much. Its long-time malaise has a lot to do with unification, weak household consumption (not least because of the on-going massive transfer of income to the east), very restrictive and pro-cyclical fiscal policies under the Maastricht regime, and the collapse of the real estate sector—Spain these days produces seven or eight times more houses per capita than Germany! The productive core, or the non-consumption related part of the economy, remains very robust."

Hüfner agrees with Posen's mantra that the German Grand Coalition should not allow recent successes to be used as an excuse to leave the country's reform agenda unaddressed.

In his critical view, Adam Posen is not standing alone. There are others who are putting similar question marks behind Germany's economic growth prospects or are even more pessimistic. Take Hans-Werner Sinn, president of the Ifo Institute, who wrote that he "essentially shares Posen's analysis and doesn't have much further to say."

Among the skeptics is also Wilhelm Hankel, who teaches at Frankfurt University and was deputy finance minister way back under Professor Karl Schiller. Together with other leading monetary economists, Hankel went before the German Constitutional Court to fight giving up the deutschemark for the euro. He sees things as even worse for Germany than Posen does because Germany is still depressing internal wage demand in a futile attempt to catch up with the real interest rate advantage it lost introducing the euro. As he explains in his new book, *The Euro Lie,* in Germany "not wages but capital costs for the Mittelstand are much too high." In his view, Germany's structural weakness in domestic consumer demand will dampen its growth potential for many years to come.

Joachim Jahnke, who produces a highly trafficked website, "Germany and Globalization" (www.jjahnke.net/index.html), and who worked for many years in the economic forecasting section of the German Ministry of Economics, sees Germany's economic and social developments even less favorably than does Posen. "Everybody is glad that a set of key economic data have improved markedly, but the question is, which ones?" argues Jahnke. "Yes, company earnings have improved, income from entrepreneurial activities and from property is up, exports are increasing." On the other side, Jahnke sees "no positive change in consumer household spending, pension, and most wage income, if adjusted for inflation." Jahnke sees behind the strong German export performance "wage-dumping," and—in relation to the euro—cost compression in the producing sectors." He predicts that in the not-so-distant future, other EU countries will no longer be able to bear the job losses caused by low wages in German export industries. And what about the much-heralded improvements in German employment? For Jahnke, "Recent lower unemployment can be explained to a large extent by an extension of temporary and part-time work and other low-wage employment that will disappear very fast if the next economic downturn sets in."

What makes Posen so unique in the context of the debate on economic growth prospects and reforms for the German economy to grow and create more jobs is this: For years, he not only pointed to enhancing labor market flexibility, reducing ancillary wages, bringing pensions and health care costs onto a sustainable path, and restructuring the tax code. That's what the Red-Green government under Chancellor Schröder put forward in their Agenda 2002–04.

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He goes beyond that. As was documented in a *Handelsblatt* series on "Deutschland von Aussen" on July 30, 2005, with reference to his forthcoming book *Reform in a Rich Country: Germany,* Posen is going beyond the "reform laundry list" of the major political parties and is becoming a pain in the neck, asking for "Reform of the Corporate Sector," for "Modernizing German Federalism," and to "Address Globalization Rather than Scapegoating It."

This is—as the current disaster in Germany's public-sector banks shows again—where Germany's politicians stop talking about reforms because they and their political parties have so much of their own regional and national influence at stake. It is in the context of pointing to the smoldering governance problems in the corporate and federal public sector that Posen probably has been developing his "counterintuitive" nightmares about the prospects of Europe's largest economy.

For someone who has been pointing for more than a decade to a German public-sector banking system that in case of the Landesbanks is run, in many instances, on business models that are not sustainable, Posen can say today: "I told you so!" Again, huge capital resources are squandered in the public domain. Again, it becomes clear that good governance is not working. When regional politicians want to control their own "Landesbank," as was in the case of Sachsen LB, things can get costly for taxpayers. But if Germany's financial sector is not supporting economic growth and employment, then question marks behind the current economic upswing are very much justified. Posen can, however, admit that in terms of corporate restructuring, major German international companies have come a long way and parts of what used to be "Germany, Inc." have vanished into post-war history. ◆