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Keynes in Lederhosen: Assessing the German Response to the Financial Crisis

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How do German and American reactions to the financial crisis compare?

How does short-time work stimulate the German economy and could it be effective in the U.S.?

Sturm und Drang has been the *Leitmotiv* of German-American economic relations since the onset of the global financial crisis in 2008. Late last year and in the run-up to the April G20 summit, U.S. critics attacked German economic policy as inadequate and a product of "boneheadedness" grounded in a failure to recognize the need to "fill the demand hole" caused by the crisis through undertaking a coordinated fiscal expansion worldwide.[1] Chancellor Angela Merkel fired back most forcefully in early June when she rebuked British and U.S. central bankers for undertaking "politically supported" money-supply expansions and called for a "return together to an independent central-bank policy and to a policy of reason." Given all the sound and fury, an observer could not be blamed for expecting to find a large gulf between German and U.S. economic policy. In reality, however, both countries' responses to the financial crisis are in their essentials similar. Differences do exist in the means by which fiscal stimulus has been deployed, but they largely reflect the different articulation of the two countries into the international economy. The public dissonance over economic policy between Germany and the United States is largely the product of the two countries being in very different places in their electoral cycles and a clash of rhetorical commonplaces used to legitimize government action in this realm. The German government has pursued a Keynesian countercyclical economic policy, but it has dressed it in garb that is compatible to national economic structure and political sensitivities.

There are several similarities between German and U.S. reactions to the financial crisis. Both countries have extended credit guarantees to financial institutions and some other firms that represent a comparable share of gross domestic product. The United States is lending to GM in exchange for equity; Germany is subsidizing the sale of GM's Opel subsidiary. Germany and the U.S. have "cash for clunkers" programs that are relatively modest in scope, but are targeted to assist the automobile sector find its footing again. Germany and the United States do differ in the central approach toward stimulating demand. The strategies pursued by the United States over the last two years, namely, large tax cuts to individuals and an expansion of infrastructure projects, offer less appeal to German policymakers and the dominant voices in the private sector because that would never be sufficient to replace demand for Germany's bread-and-butter export sector, which is producer goods. It can half-jokingly be said that no domestic economic stimulus could ever be big enough to induce a German family or local government to buy a computer-numerically-controlled lathe or 10,000 liters of toluene. More to the point, no stimulation of the domestic economy could ever be large enough produce enough domestic demand to replace the dramatic drop in German producer-good exports. Cautious voices, including that of Chancellor Merkel, have also expressed skepticism about the advisability of attempting a rapid radical reorientation of demand toward the domestic German economy, particularly given the country's shrinking and aging population.[2]

The principal step the Germany government has undertaken—expanding the use of "short-time work" (*Kurzarbeit*)—reflects the priority afforded to sustain the export sector. Short-time work offers an opportunity for firms to keep their existing skilled labor force largely in place even when orders have fallen off and provides an incentive to upgrade skills. The program permits employers to cut working time by up to 50 percent. Employees placed on short-time work receive between 60 and 67 percent of their net foregone wage from the German Federal Employment Agency. The Agency waives the employer's share of payroll taxes covering pensions and unemployment insurance (i.e., just under 10 percent of the gross wage) for firms that use the short time to train employees. Since October 2008, over 2.6 million employees at over 80,000 companies have worked short time. In late November 2008, the government extended the maximum duration for short-time work from 12 to 18 months; and in June 2009, it extended it further to 24 months. Short-time work has been particularly attractive to firms in Germany's export-oriented manufacturing sector. Stuttgart, the stronghold of German auto and machine-tool manufacturing, has been called "the capital of short-time work."[3] Short-time work is a very German form of Keynesianism. It provides for countercyclical spending in a way that sustains the export-oriented core of the economy. It even provides a modest incentive for firms to improve the skills of their employees. Short-time subsidies reduce labor costs, but limit declines in consumer purchasing power. Indeed, during the spring of 2009, German exports and investment fell off by 9.7 and 7.9 percent respectively, but consumer spending rose by 0.5 percent.

The International Monetary Fund and other authorities judged the German stimulus package as "substantial, and … at least in a comparable range to anyone else," even before the German government expanded the use of short-time work.[4] Still, it is difficult for German politicians to concede openly the extent to which they are stimulating their economy. Fiscal probity has been a touchstone of German economic policy since the hyperinflation of the 1920s. The prevailing mood in Germany is that its citizens have been virtuous over the last two decades. Private consumption has stagnated for a decade, domestic savings have remained stable at around 10-12 percent of personal income, and individual debt has not expanded. Germany experienced no housing boom. Implementing a stealth stimulus package through short-time work permits politicians to engage in substantial Keynesian-style spending without having to pass a stimulus package that is visible as such. American observers and policymakers have not perceived the size and significance of Germany's short-time work program because they have been looking for a stimulus package like that found in the United States and they have had difficulty assessing the impact of a program that is cast in terms of qualifying regulations rather than an expenditure.

It is important to consider the impact of the different approaches toward stimulating an economy. If the United States government had offered a comparable program of short-time work, the financial crisis would have played out differently. A U.S. short-time work program would have provided more widespread and even assistance, which would have been far more effective at protecting the industrial base of the economy and counterbalancing regional disparities in the impact of the financial crisis. For example, employees at Ford, auto suppliers, and manufacturers outside of the automobile industry would all have been eligible to receive short-time subsidies. Detroit and Michigan would be in less desperate shape, as would California, Rhode Island, and other states that the financial crisis has hit disproportionately hard.

Short-time subsidies do produce their own problems, however, which are not to be underestimated. Short-time payments are regressive and go disproportionately to insiders with jobs. They are expensive and can be difficult to terminate, since doing so would risk subjecting the economy to a sudden shock. If the current financial crisis turns out to be "V-shaped," like the East Asian economic crises of the 1990s, then Germany's emphasis on short-time subsidies for stimulus could very well pay off, because it would have helped to preserve the export-oriented manufacturing base. If, however, the current crisis plays out much more like Japan's experience in the 1990s—that is, if the downturn takes an "L-shape" and slow growth persists worldwide for some time—the decision to focus on short-time subsidies may ultimately prove quite costly for Germany. A considerable amount of public funds would have been spent to preserve the status quo instead of getting on with adjusting to a new economic environment that portends to be far less friendly to export-dependent countries like Germany.

1 For example, Paul Krugman, "The Economic Consequences of Herr Steinbrueck," *Paul Krugman's Blog*, 11 December 2008, <http://krugman.blogs.nytimes.com/2008/12/11/the-economic-consequences-of-herr-steinbrueck/>.
2 *Financial Times*, 17 May 2009.
3 *Frankfurter Allgemeine Zeitung*, 19 May 2009.
4 International Monetary Fund, "Transcript of a conference call with Ashoka Mody, Assistant Director, European Department, on the Release of the 2008 Article IV Consultation with Germany, 22 January 2009, http://www.imf.org/external/np/tr/2009/tr012209.htm.

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