Flossbach von Storch
RESEARCH INSTITUTE

MACROECONOMICS 09/01/2025

The American Exceptionalism

by THOMAS MAYER

Abstract

"American Exceptionalism" is on everyone's lips on the financial markets today. This is because those who have bet on American Exceptionalism on the stock markets have been able to achieve higher returns than elsewhere over the last decade and a half, while those who have bet against it have lost out. However, stock markets are always prone to "irrational exuberance". The fear that a bubble may have developed is justified and a major setback cannot be excluded. However, there are indications that the exceptional development is not completely "irrational" but has a real economic background.

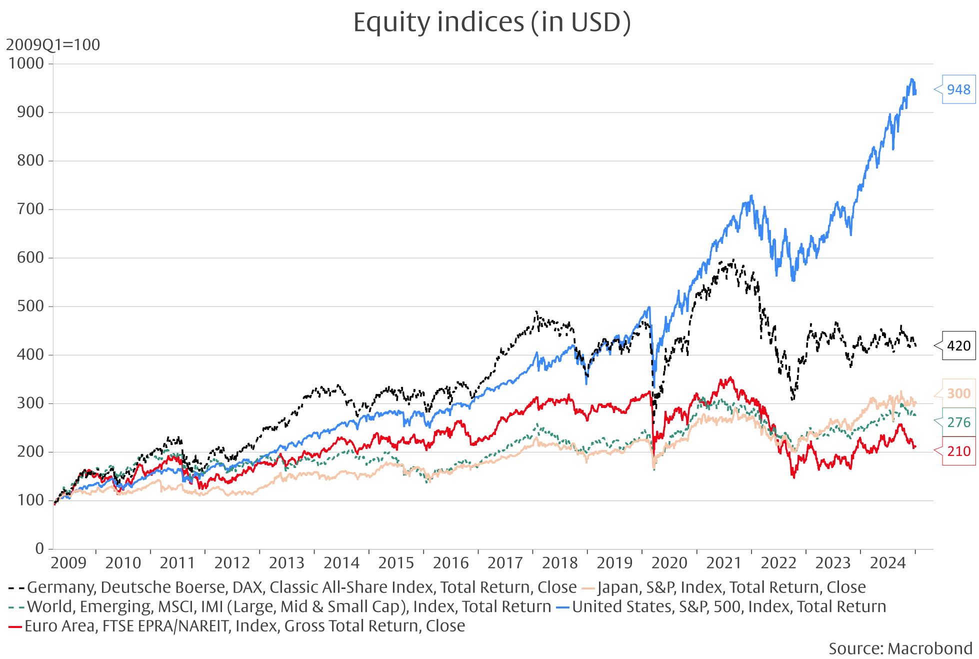
Zusammenfassung

Auf den Finanzmärkten ist der „amerikanische Exzeptionalismus“ heute in aller Munde. Denn wer an den Aktienmärkten auf den amerikanischen Exzeptionalismus gesetzt hat, konnte über die letzten eineinhalb Jahrzehnte eine höhere Rendite erzielen als anderswo, wer dagegen gewettet hat, hatte das Nachsehen. Allerdings neigen Aktienmärkte immer wieder zu „irrationalem Überschwang“. Die Furcht, dass eine Blase entstanden sein könnte, ist berechtigt und mit einem größeren Rücksetzer muss man rechnen. Doch gibt es Hinweise darauf, dass die exzeptionelle Entwicklung nicht völlig „irrational“ ist, sondern realwirtschaftliche Hintergründe hat.

Today, "American Exceptionalism" is on everyone's lips on the financial markets. However, the view of the special nature of the USA has a long history. When the French aristocrat Alexis de Tocqueville travelled to the USA in 1831, he found that "the situation of the Americans ... is quite exceptional". It could be assumed "that no other democratic people will ever find themselves in a similar situation".[1] Since then, de Tocqueville has been credited with the discovery of "American exceptionalism".

Over the centuries, the "exceptionalism" has sometimes been demonised, sometimes glorified. It has definitely had a strong influence on the capital markets. Despite recurring doubts, the US dollar is the world's reserve currency and American government bonds are considered the safest investment worldwide. Only 4% of the world's population lives in the USA. But the country accounts for around a quarter of global gross domestic product and a third of global corporate profits. The US equity market accounts for two thirds of the capitalisation of the MSCI World Index.[2] Over the past decade and a half, those who have bet on American exceptionalism on the stock markets have been able to achieve higher returns than elsewhere, while those who have bet against it have lost out (Chart 1).

Chart 1:



[1] Alexis de Tocqueville, Democracy in America, 1840.

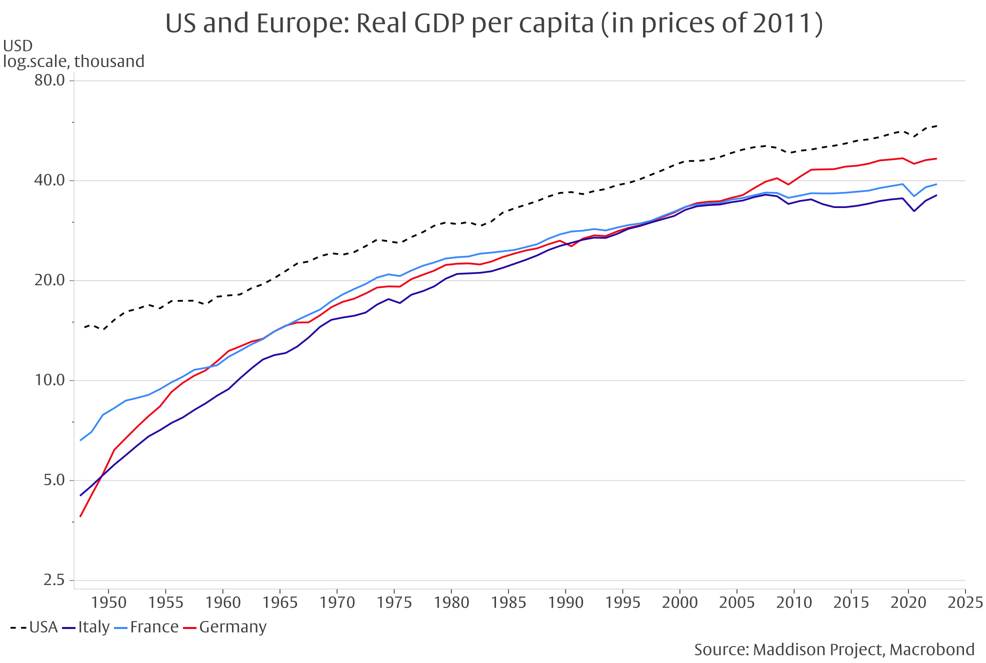
[2] Louis-Vincent Gave, The Relentless March of American Exceptionalism, Gavekal Research, December 16, 2024).

It is well known that equity markets are always prone to "irrational exuberance", which has led to strong doubts about the exceptional performance of the US market over the course of 2024.[3] Given the popularity and therefore high valuation of American equities, this is easy to understand. The fear that a bubble may have developed is justified and a major setback is to be expected. However, there are indications that the exceptional development is not completely "irrational" but has a real economic background.

Overall economic performance

In the Financial Times on 10 December, Martin Wolf, the paper's chief economic commentator, sang the familiar song of declining growth rates in industrialised countries. "The 'growth miracle' after 1945, especially in continental Europe and Japan, was a one-off," Wolf said.[4] The development of real gross domestic product (per capita) plotted on a logarithmic scale in Chart 2 serves as a key witness for this assessment (which is also shared by others). As the growth rates correspond to the first difference in these series, the continuously falling gradient of the curves shows the decline in growth.

Chart 2:



However, it is not necessarily the case that a falling positive growth rate should indicate declining economic momentum or result in less room for manoeuvre in the distribution of income. If the real gross domestic product increases, absolute changes must become ever greater so that the growth rate remains constant. However, this contradicts the principle of marginal productivity decreasing with

[3] See e.g. "What do investors need to look out for in 2025", Financial Times, 14 December 2024.
[4] "Reckoning with an era of slow growth", Financial Times, 10 December 2024.

increasing production and marginal utility decreasing with increasing prosperity. Moreover, the absolute increase in GDP and thus the absolute scope for distribution can also increase with a slowly falling growth rate.[5]

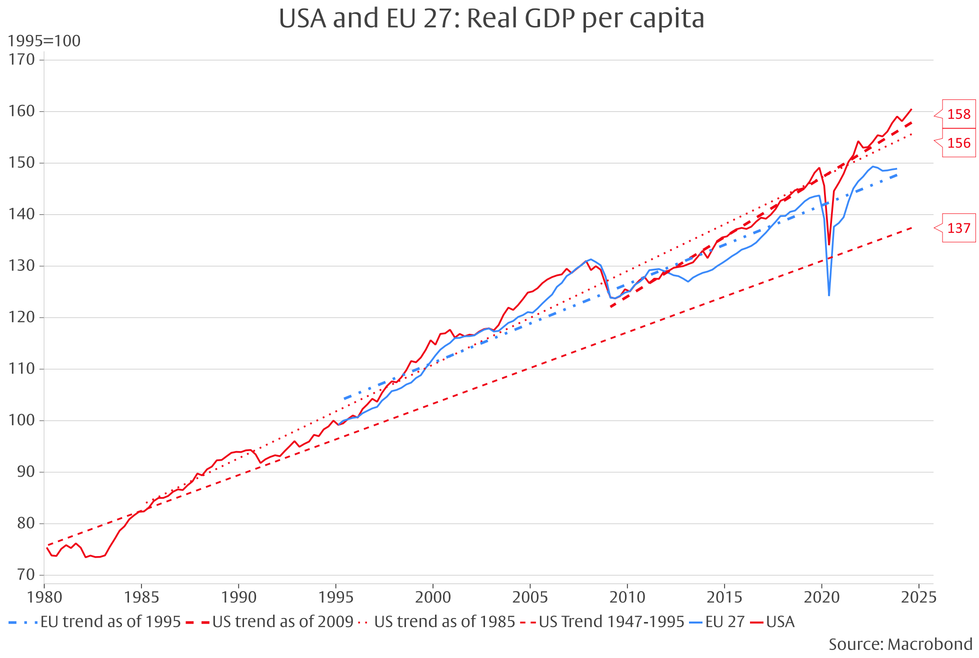
For this reason, it makes more sense to look at the absolute changes. Chart 3 shows the real gross domestic product per capita in the USA and the European Union (normal instead of logarithmic scaling). From this perspective, three characteristics of the development can be recognised:

- If real GDP per capita in the USA had continued to follow its linear trend from 1947 to 1995, it would be 17 per cent lower today.[6] The reason for this is that from 1947 to 1995, GDP rose by 1.4 percentage points of its 1995 value each year, but thereafter at a faster rate.
- If the trend begins in 1985, the annual increase is 1.8 percentage points. If the trend starts in 2009, the annual increase is 2.3 percentage points.
- By contrast, real GDP per capita in the EU has followed a fairly stable trend since 1995 (earlier harmonised figures are not available), with an annual increase of 1.5 percentage points on its 1995 value. GDP was above its trend for some time until the Great Financial Crisis of 2007-2008, and then below it.[7]

One could deduce from this that the development in the USA has experienced two new impulses since 1947: firstly, through the supply policy of the Reagan administration in the early 1980s, which to a large extent created the basis for digitalisation, and secondly, through the expansion of the internet economy, which picked up speed particularly after the Great Financial Crisis.[8]

[5] If, for example, real GDP is 100 in year zero and the growth rate is 3%, then the absolute changes increase from +3 points in year 0 to+ 3.2 points in year 10, even if the growth rate falls by 0.05 percentage points per year. Only if the growth rate falls by more than 0.06 percentage points per year do the absolute annual changes decrease.
[6] A linear trend with R^2=0.98 gives a significantly better fit than an exponential trend (R^2=0.73).
[7] An alternative interpretation of the development would be that GDP in the EU increased at a similar rate to GDP in the USA from 1995 to 2008, but that the Great Financial Crisis then caused a break in the trend, after which the increase continued at a much slower rate than in the USA.
[8] The deregulation promoted by Reagan lifted many restrictions that had previously hindered competition in the telecommunications industry. This enabled new companies to enter the market and encouraged innovation. The privatisation of state-owned companies and the liberalisation of the market allowed new technologies to be developed and disseminated more quickly, while tax cuts and other economic policy measures contributed to the rapid expansion and modernisation of networks.

Chart 3:



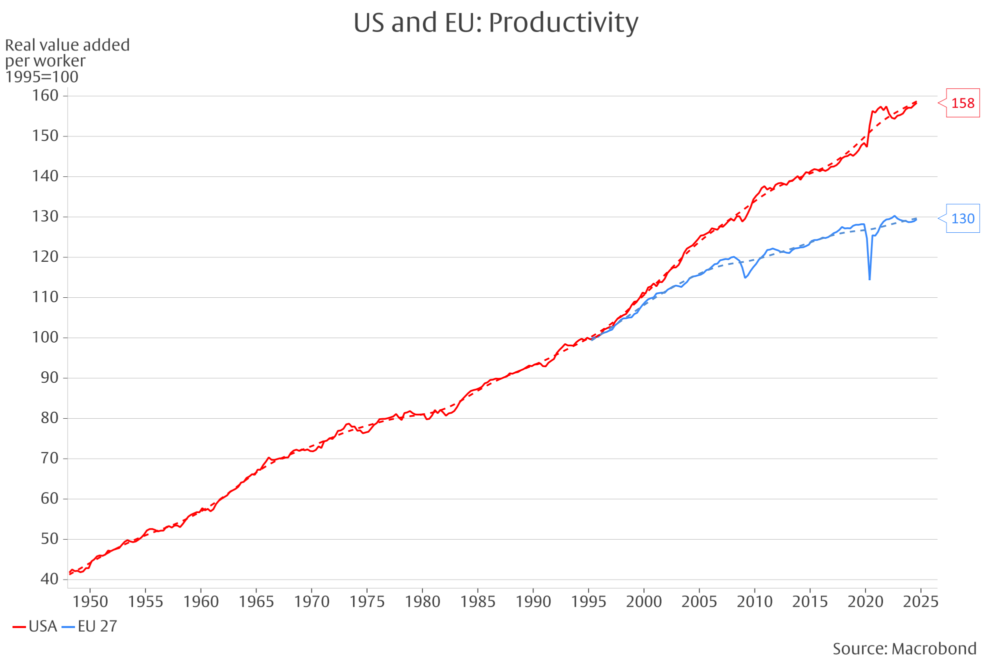
Productivity

Since the founding of macroeconomics by John Maynard Keynes in the 1930s, economic forecasters have tended to focus on the demand side of gross domestic product. One consequence of this is the misconception that the state can ensure economic growth with its fiscal policy and the monetary policy of its central bank. In reality, however, government fiscal and monetary policy can only influence demand. If, for whatever reason, domestic supply does not follow the demand stimulated by policy, the excess demand is satisfied by an increase in net imports. Falling exports and rising imports create a deficit in the foreign trade balance. Domestic real gross domestic product remains unaffected in this case.

Because of this misconception, the more expansive economic policy of the US authorities is often cited as the reason for the better development of the US economy than (for example) the European economy. In reality, however, the current account balance of the US economy has improved from -5.9 per cent of GDP in 2006 to -2.1 per cent in 2019 and has fallen back to an estimated -3.7 per cent in 2024 due to the turmoil in the years of the coronavirus pandemic. The actual reason for the relatively strong growth of the US economy must therefore be sought on the supply side.

Growth in labour productivity - measured as gross value added per person employed - has been significantly higher in the US than in the European Union, especially in recent years (Chart 4). From 1948 to 1995, the average annual increase in the trend was 1.3 percentage points of the 1995 value. In the period since 1995, this increase has risen to 2 percentage points. In contrast, the increase in gross value added per person employed in the European Union since 1995 has only been one percentage point. As a result, labour productivity in the US economy is now 21.5 percent higher than in the EU economy.

Chart 4:

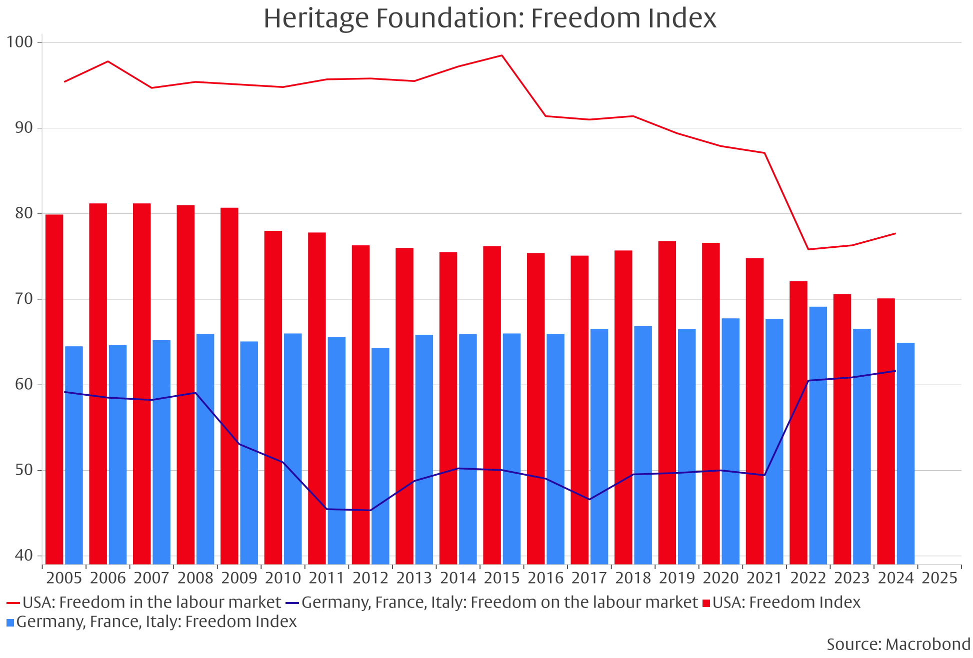


Causes

There are two direct reasons for the USA's lead in per capita productivity. Firstly, productivity per hour in the USA is a good 17 per cent higher than in the EU. Secondly, the average annual working week in the USA is a good 4 per cent longer than in the EU. The first circumstance is likely to be directly attributable to a considerable extent to the technological leadership of the USA in the field of digitalisation and indirectly to an economic environment that has made this leadership possible. The second circumstance could be due to the lower union and government influence on the labour market in the USA.

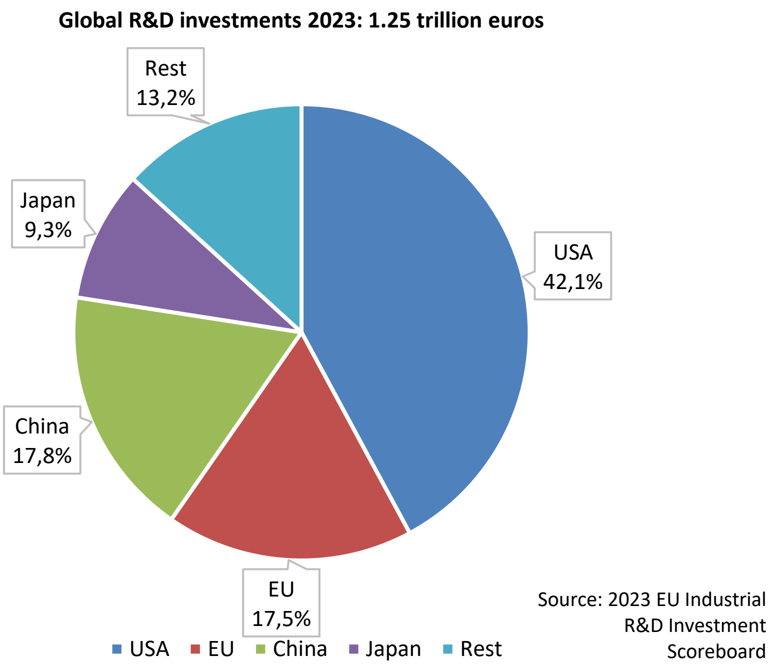
In fact, the Heritage Foundation's Freedom Index shows a higher level of both general freedom and freedom in the labour markets in the USA compared to the average of the three largest EU countries (Chart 5). However, the gap has narrowed in recent years. The index values have fallen in the USA, while they have risen in the EU countries, particularly in the area of the labour market. This may have been due to structural changes in the French and Italian labour markets during the pandemic years.

Chart 5:



Nevertheless, the USA remains the leader in the research and development of new technologies. As the European Commission's R&D Investment Scoreboard shows, companies in the US were responsible for around 42 per cent of the expenditure of a global sample of 2,500 companies in 2023 (Chart 6). Companies in the EU are in third place, just behind China.

Chart 6:



However, it is not only the total amount of expenditure on research and development (R&D) that justifies technological leadership, but also its quality. A study recently published on the EconPol Europe platform shows that the public sector in the European Union spends 0.7% of gross domestic product on R&D, roughly the same proportion of economic output as the private sector in the EU (1.2% of GDP in the EU compared to 2.3% in the USA).[9] In addition, R&D expenditure in the EU is concentrated in the area of "medium technology" (for example in the automotive industry), while in the USA the focus is on cutting-edge technology. The share of US companies in global expenditure on software development is 75%, while the share of EU companies of 6% is even lower than that of Chinese companies.

The authors of the study conclude: "Escaping the middle technology trap would foster growth and increase the geopolitical weight of the EU. But to achieve this, governance must match ambitions. Simply put, the EU does not have the institutions it takes to meet the 21st century innovation challenge" (p.4). However, if one looks at the drivers of American exceptionalism, it is easier to conclude that the EU lacks the necessary entrepreneurial spirit to translate new scientific findings, which are not lacking in the EU either, into successful commercial activities.

The right governance is less likely to lie in the creation of new institutions than in the abolition of excessive bureaucratic controls on companies. With the General Data Protection Regulation, the EU Supply Chain Act, the EU Taxonomy Regulation for the financial sector, the "Green Deal" or the Corporate Due Diligence Directive (CSDDD), to name just a few regulations, the European Union has created a thicket of regulations that is still being thickened by national regulations. In comparison, the density of regulation in the USA appears rather modest.

Trump: curse or blessing?

US President Donald Trump bears a certain resemblance to the Roman god Janus. In Roman mythology, Janus symbolises the duality inherent in the world and people: creation and destruction, life and death, light and darkness, beginning and end, etc. Everything has a good and a bad side. In his first presidency, Donald Trump has cut taxes, identified China as an adversary and forced Europe to work harder in its own defence. But he is also a convicted felon, a notorious liar and a threat to the rule of law. It remains to be seen with which of these two faces he will go down in history. In the area of economic policy, however, the positive side for the entrepreneurial spirit is likely to prevail.

Trump's trademark is increasing trade tariffs. However, under the influence of his techno-libertarian supporters, the threat of tariffs could be used as a tool to pursue foreign policy goals. If the threat is successful, the tariffs could be reduced or even

[9] C. Fuest, D. Gros, P.-L. Mengel, G. Presidente and J. Tirole: EU Innovation Policy - How to Escape the Middle Technology Trap. Econpol @ cesifo, Institute for European Policymaking @ Bocconi University, and Toulouse School of Economics, 2024.

cancelled. Against the reduction of regulations and tax cuts promised by Trump possibly stand a further increase in national debt and the degeneration of capitalism into "crony capitalism".

However, a dismantling of the welfare state by the "Department of Government Efficiency" led by Elon Musk and Vivek Ramaswamy could slow down the rise in national debt and turn "Crony Capitalism" into a second "Gilded Age", just like at the end of the 19th century. Mark Twain used this term to describe the economic heyday in the USA after the Civil War from 1861 to 1865, during which the rather agrarian and rural United States was transformed into a modern industrial society through industrialisation and the rapid growth of cities.[10]

Through the disruption he will cause, for which the EU countries are hardly equipped, Trump could consolidate American exceptionalism in the new era characterised by technological and geopolitical changes. The financial markets seem to rate the opportunity for this higher than the risk associated with Trump's presidency. [11]

The fact that betting against American exceptionalism has only brought losses in the past and therefore appears to be very risky may also play a role here. And if Trump does not bring the blessing that some had hoped for, American exceptionalism could also be reinforced by the fact that the rest of the world is far worse off than the USA.

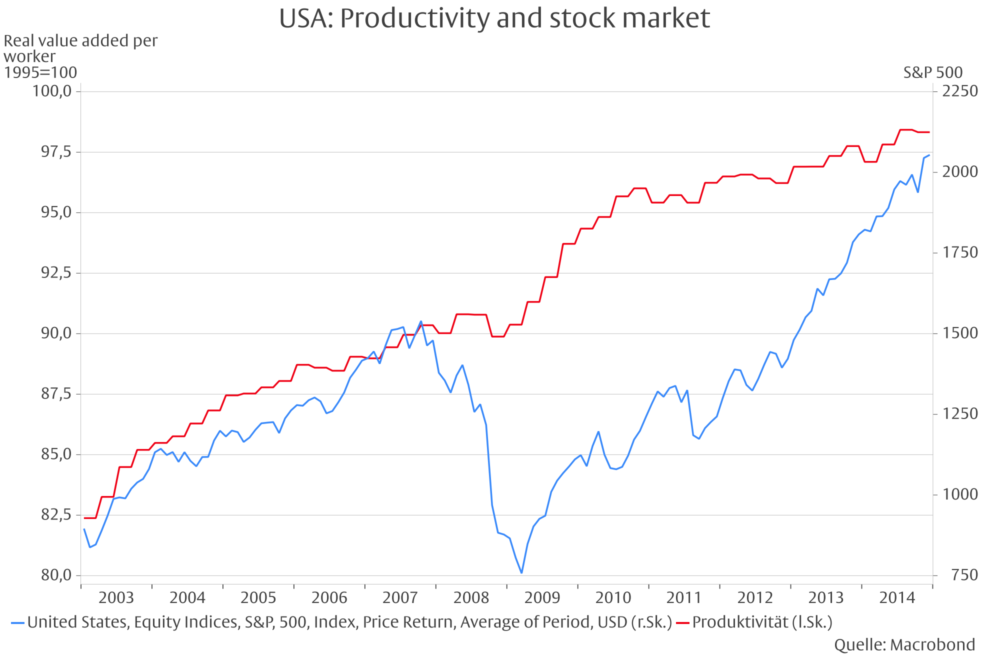
Wisdom of the Crowd or March of the Lemmings?

Because it is so convincing, the financial market players' bet on American exceptionalism is a "crowded trade". It can therefore be seen as the "wisdom of the crowd" or the "march of the lemmings". A resilient investment strategy cannot ignore the probability that the bet reflects "wisdom of the crowd" but must ensure that all is not lost if the lemmings fall into the abyss. Consequently, a portfolio would basically have to be trimmed for "American Exceptionalism" but have a reserve in case the lemmings crash.

The period around the Great Financial Crisis may give some guidance for this (Chart 7). With the boom in the property market and the financial sector, growth in real value added per employee initially declined. During the crisis year of 2008, value added fell as a large number of property projects proved to be bad investments. However, once the crisis had passed, value added rose more steeply than before for several years.

[10] The majority of economists assume that close relationships between politicians and companies suppress competition, misdirect taxpayers' money and hinder economic growth. But there is a lack of empirical evidence for this (see "Cronyism is a problem. But not always an economic one", The Economist, 5 December 2024).
[11] For a list of possible risks, see Gave (op.cit.).

Chart 7



The stock market anticipated the slump as early as 2007 but missed out on a new upswing for some time. Today, a correction of earlier share price rises may well also come sooner or later. However, it would be wrong to conclude then that the American exceptionalism would have come to an end and conditions like those after the bursting of the Japanese bubble economy in the early 1990s would prevail. More likely, American exceptionalism will continue, and financial markets will recover. A major setback would therefore offer a new opportunity to enter the market, provided you have sufficient cash reserves.

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