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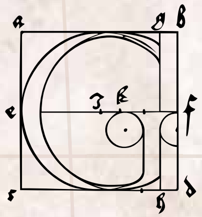


THE GERMAN MODEL

OVEREXPOSED TO AN UNDERREGULATED GLOBAL ECONOMY

By Dr. Michael Dauderstädt

Economic security, understood as the continuous fulfillment of the conditions required to sustain economic welfare, is crucial to stability and prosperity in Germany. Welfare should not be confused with growth of the gross domestic product (GDP) alone, but encompasses wealth distribution and external effects not measured by GDP, such as a healthy environment. However, at its core, economic welfare is the production and consumption of goods and services, either via market-oriented commercial activities, to a large extent private business or by households, and the public sector provision of public goods and services. In a modern capitalist system with a monetized economy, wealth includes not only physical and human capital, but also financial wealth, making a stable financial system a core part of economic security.

Economic activity depends on many conditions for sustainable execution:

- Politically, it depends on a reliable legal and institutional framework such as property rights or contractual law;
- Ecologically, it depends on the absence of environmental catastrophes such as floods or droughts;
- Economically, it depends on access to crucial inputs such as raw materials, capital, labor and knowledge;
- Financially, it depends on a stable monetary and financial system preventing inflation and reducing the risks of capital loss.

To some extent, these conditions will be met within each nation's economy, depending on the size of the country and its policy regarding economic openness. Huge countries, such as the United States and Russia, may find most inputs and markets within their own borders. The communist bloc (and North Korea today) adopted autarkic economic policies to reduce dependency on unfriendly capitalist states. But today, economic security depends on the safe maintenance and management of foreign economic relations. This is certainly the case for Germany: Though a relatively large economy, it is deeply integrated into the European and global economy.

GERMAN RELIANCE ON EXPORTS

For a country of its size (82 million people, GDP of 2.4 trillion euros), Germany's share of foreign trade is very high. Annual German exports amount to almost 1 trillion euros, or about 38 percent of GDP. Imports are somewhat lower, about 32 percent of GDP, leading to a trade surplus of about 150 billion euros. This surplus is somewhat reduced by a deficit in the services trade, particularly tourism (Germany has a negative balance on tourism of about 1.5 percent of GDP).

The country's capital account is, as it must be, the mirror image of the current account, making Germany a net capital exporter with a growing net investment position as a global creditor. Germany exports capital in various forms, such as transfers (contributions to the European Union or foreign aid), foreign direct investment and lending (buying financial products or government bonds). Germany also imports labor, albeit at a much lower level than in the 1960s. There are almost 2 million foreigners employed in Germany.

Germany's primary industrial exports — machinery, electrical equipment and cars — leave German industry well-placed to benefit from the unequal growth in the world economy, which has spurred demand for investment goods and luxury cars. German imports also consist mainly (60 percent) of manufactured goods. This pattern shows strong intra-industry trade. Nonetheless, the German economy's comparative advantage is revealed by the composition of imports relative to exports. Raw materials and food constitute 10 percent and 9 percent, respectively, of all imports, while their share of exports is much smaller (1 percent and 6 percent).

Germany's integration into global markets for capital and labor is somewhat less pronounced than for trade. Germany is not a major target country for foreign direct investment (FDI) and its investments abroad are much higher than foreign investments in Germany. In most years, incoming FDI does not exceed 50 billion euros. German FDI has often focused on establishing production networks in Central and Eastern Europe.

As a net exporter of goods and services, Germany must be a net exporter of capital. Nonetheless, it receives substantial inflows of portfolio investment that are overcompensated for by strong outflows. Foreigners like to buy German government bonds, and they hold a large portion (about 40 percent) of Germany's substantial public debt (about 2 billion euros, or more than 80 percent of GDP). Overall, Germany is a net creditor to the rest of the world. In 2010, German banks had claims against foreign debtors of 2.4 billion euros, of which a third was owned by foreign banks, about half by private enterprises and the remaining share by governments.

Germany's international integration is based on a complex structure of international agreements and institutions. Germany is a member of many global bodies that manage global economic governance (the World Trade Organization, the International Monetary Fund, the World Bank, etc.). But Germany's membership in the EU, which constrains national economic policy, is much more important. There is no sovereign national monetary and exchange rate policy, because this is the prerogative of the European Central Bank (ECB); fiscal policy must follow European rules regarding deficits and debts; trade policy, such as tariffs, are set by Brussels; and subsidies are subject to approval by the EU Commission.

Many other policy fields are coordinated and/or subject to majority rule within the EU. This integration has immediate economic and financial repercussions. Germany is the largest net contributor to the EU budget, a "shareholder" in the ECB, and, as the ongoing eurozone economic crisis unfolds, a major contributor and guarantor of the diverse funds and schemes to "save the euro."

RISKS AND CHALLENGES

Risks to basic market functions are currently limited. There is no apparent danger that Germany will not be able to buy necessary inputs (in particular, natural resources) abroad, or sell its output. Risks include potentially higher prices for inputs and declining revenues from stagnating demand or increased competition. Either could lead to declining terms of trade, which hurts GDP.

However, concerns about its trade position have strongly influenced Germany's economic policy. Pride in its exports, on the one hand, and concern about supposedly declining international competitiveness, on the other, have dominated German economic policy discourse since the late 1970s.

German financial wealth was hit by the 2009 financial

A customs officer inspects German-made Volkswagens and Audis to be loaded on ships in Emden for export. German industrial competitiveness, combined with a single European currency, has brought benefits to the continent. But it has also contributed to disharmony in the eurozone.

GETTY IMAGES

crisis but mostly recovered in 2010. Nonetheless, recent studies have shown that German savers/investors lost 10 to 20 percent of funds invested abroad, if accumulated current account surpluses are compared to the actual increase in the net asset position.

The financial crisis of 2008/2009 revealed risks and opportunities. Although the crisis emerged initially in the U.S. mortgage market, Germany realized its own banking system had been seriously affected, too. Germany has benefited substantially from the stimulus packages adopted by other governments, notably in the U.S. and China.

More recently, two developments have fed skepticism of the wisdom of Germany's export-led model. First is the eurozone crisis, which is partly fueled by growing trade imbalances. While Germany runs large surpluses, Greece, Spain, Italy and France have corresponding deficits. These imbalances are caused by a divergence of unit labor costs, which declined in Germany and increased strongly in the southern EU states. In 2009, then-French Finance Minister Christine Lagarde voiced concerns about Germany's "beggar-thy-neighbor" policies, triggering a fervid debate in Germany that continues today.

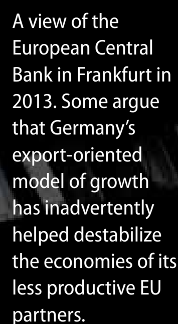
The second development is rising inequality within Germany. Besides being a problem itself, it has strong links to Germany's world market integration. Wage restraints, labor market reforms and welfare cuts have often been justified in the name of international competitiveness. Globalization and the need to maintain competitiveness allegedly require a leaner welfare state and lower wages. However, inequality and poverty continued to grow even when the economy picked up with increased exports.

Advocates of the traditional export-led growth model like to stress that Germany owes its recent growth to exports, and this successful model should not be disrupted. They argue that Germany's strong exports help balance the eurozone's external accounts, given the weaker members' preponderance of imports. The rise of emerging economies, in particular China and India, is considered a threat to Europe's and Germany's prosperity — a threat that can only be deflected by a strong focus on competitiveness. Christoph Schmidt, a prominent German economist and member of the government's economic advisory board, put it this way: "We cannot draw ourselves out of the morass," implying that growth only results from exports (surpluses). Through this logic, one wonders how the world economy can grow without exports to Mars, let alone export surpluses.

Germany has run trade surpluses throughout most of its history (the years immediately following reunification being the exception), which suggests its recurrent concern with competiveness is an obsession rather than a true problem. More risky are the consequences of economic imbalances, because these endanger the purchasing power of — and thus demand by — trading partners, and the value of the accumulated German surpluses, which constitute its net foreign investment position. Germany has become a major creditor in the world economy.

Changes in Germany's growth model will be triggered by external challenges rather than domestic reforms. A deepening of the eurozone crisis and a decline in emerging market growth are more important, because both will harm the prospects of German export industries. The introduction of a legal minimum wage and increased taxation of higher-income households might help equalize income distribution and lead to higher imports and/or demand for goods and services.

The eurozone crisis remains crucial. Germany is largely responsible for the duration and depth of the crisis. If the German government had endorsed mutual responsibility of all eurozone governments, a common European bond and an active role for the ECB in the bond markets and as lender-of-last-resort, the crisis would have ended immediately in May 2009. Germany's reluctance to save Greece and other highly indebted euro countries (Ireland, Portugal, and Spain) increased panic in the financial markets and raised the cost of additional rescue packages. Germany's — and the EU's and IMF's — insistence on austerity policies in Greece, Ireland, Portugal and Spain exacerbated the crisis. The ensuing recessions in those countries aggravated their capacity to service their debt and increased the crucial debt/GDP ratio (by lowering GDP).



A view of the European Central Bank in Frankfurt in 2013. Some argue that Germany's export-oriented model of growth has inadvertently helped destabilize the economies of its less productive EU partners.
REUTERS

Recession, or even depression, still looms as a possibility in the eurozone. Banks that relied on government bonds as assets and collateral have been close to losing creditworthiness. Ratings agencies first downgraded eurozone states and then eurozone banks. Only massive injections of liquidity by the ECB and other central banks could have averted that crisis. The corporate sector and households are affected by the credit crunch. Growth forecasts for the EU and the global economy have been revised lower. For an export junkie such as Germany, this foreshadows a painful decline in sales.

As a global creditor, Germany has to worry not only about the European economy and financial system, but also global capital markets. The value of German assets invested abroad depends on their stability. Supervising banks, regulating capital markets and macroprudential supervision by various national and supranational entities will all have an impact on the long-term safety of German wealth.

Apart from these narrow economic risks, other risks exist, such as global ecology and the security of global trade infrastructure and communication. Although international efforts have reduced the recent danger posed to sea transport by piracy, new concerns about the safety of the Internet have arisen. As the Internet's importance has grown, its vulnerability to piracy and spying endangers businesses and the privacy of individuals and institutions.

Planetary ecology is a major increasing risk. Global warming theory predicts that growing emissions of greenhouse gases such as carbon dioxide will increase the risk of flooding, both on the seacoast (because of rising sea levels) and away from the coasts (because of strong rainfall of the type that occurred in 2013 in East and South Germany). Although Germany is in a relatively safe geographic location and climate zone, recent meteorological events highlight its vulnerability. In addition, catastrophes abroad could harm Germany's trading partners. The country is also home to a major global reinsurance company (Munich Re) that is exposed to these costs.

COPING WITH ECONOMIC SECURITY RISKS

National and international efforts are both needed to cope with the risks. Germany has adopted many policies to deal with these challenges. But during the present eurozone crisis, its policy response has often been too little, too late. In particular, Germany has barely begun to tackle the underlying imbalances caused by its export mania and weak domestic demand. Critical analysts (often close to trade unions) believe that the two problems are intertwined and require higher wage growth in Germany, in accordance with long-term productivity growth and the ECB's target inflation rate of 2 percent.

Given the crucial role of the banking sector in the economy and in the financial crisis, a European banking union, including centralized regulation and a single supervisory and resolution mechanism, must be created to restore credit and confidence in the weaker eurozone countries. Germany has been a hesitant partner focused on narrow domestic concerns rather than systemic stability.

The problems in the global financial system, dangerous economic imbalances, the threat of recession, climate change — all these issues can be addressed only through strong cooperation within the EU or at the global level through the major economic powers represented in the G20. Overall, Germany's economic security depends on the readiness of other nation states to join cooperative efforts to mitigate risks that will affect all, at some level or another. □