The Empire *Strikes Back*

BY LUDGER SCHUKNECHT

Why Germany's exports and current account surpluses benefit other countries.

Whenever economists are barking up a tree, it is worth asking whether this profession so prone to herd mentality got the right tree. Over recent years it has become a favorite pursuit of part of the economic commentariat and certain institutions to chide Germany over its current account surplus. Europe's largest economy, so the chorus goes, is pursuing "beggar-thy-neighbor" policies, thereby "destroying demand and taking away jobs elsewhere." Worse, being a notorious exporter, Germany apparently also forces its wrong approach onto others. Under German influence, the argument runs, the eurozone unfairly projects its own adjustment on the rest of the world, with the result being a "creeping onset of deflation, mass joblessness, thwarted internal rebalancing, and over-reliance on external demand."

Germany's example is seen as spreading a dark cloud of bad consequences: "There isn't enough spending. Many policymakers still don't get it." And, again, appeals to fix things invariably turn to the European Central Bank: "Can Draghi get Germany to spend?"

The quotations above are from the *Financial Times,* the *Wall Street Journal,* and the *New York Times,* though there are many others in this chorus, among them certain international institutions. Add to this the view that the Germans are too unintelligent to invest the money they "extracted" from deficit countries (the "stupid bankers from Düsseldorf"), and it is understandable that a lay person might think that the Germans have got economics completely wrong.

Much of the criticism of Germany is based on a Keynesian view of the world where growth comes from demand and global demand is a zero sum game. In this view, macroeconomic fine-tuning is used so as to "rotate demand," as the International Monetary Fund likes to put it. But is it as easy as that? I don't think so.

Ludger Schuknecht is Director General at the German Ministry of Finance, Berlin.

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

BUSTING MYTHS: GERMAN EXPORTS ARE NO BANE FOR THE WORLD

Let's start with a summary of what German current account surpluses are not: They are not harmful. They are not the result of policy distortions such as manipulated exchange rates or export subsidies. They do not aim at amassing foreign reserves in the Bundesbank's coffers. They do not come about because German industries are somehow protected from foreign competition. They do not result from German workers being paid unfairly low wages.

German exporters meet the demand of the global market fairly and competitively. This came about as the result of efforts by the private sector and at times controversial government reforms after the German economy went through a rough patch in the 1990s. But even more important: Germany's exports not only benefit Germans, they very significantly benefit other countries as well—in at least three ways. This side of the story is rarely told.

First, Germany's strong export growth has been coinciding with more or less equally strong import growth in recent years. Since David Ricardo, few people have denied that trade boosts welfare and growth. Put simply, Both sides benefit. Germans benefit from buying Chinese consumer electronics while the Chinese benefit from German cars.

Second, the export of German capital goods and even more the creation of value chains via foreign production and joint ventures have helped the development of industry within and the transfer of know-how to many emerging economies. Workers in Poland, Korea, and many other countries would certainly not be amused if Germany suddenly told them, "Sorry, our trade surplus is too high; we cannot supply you with machines anymore." By the way, it is no coincidence that the complaints about Germany do not come from Asia, Eastern Europe, nor as a matter of fact from Spain.

Third, the German current account surplus reflects a lot of foreign direct investment. Is this bad? When German savings flow, for example, into building a factory in Romania, it is difficult to argue that this should be undesirable. According to Bundesbank data, companies supported by German FDI generated an annual turnover of €2.4 trillion and had 6.5 million employees in 2012.

Do German surpluses mean that the country does not contribute enough to international demand? The fact is that Germany is the only major industrial country that has kept its global import share stable since the financial crisis. Imports from the rest of the world to Germany have grown by €100 billion or 10 percent since 2010. By contrast, increases for Japan, France, and the United Kingdom were respectively €23 to €24 billion. And even the United States' increase of €135 billion (all figures adjusted for price developments) does not compare favorably, given that its economy is four times the size of Germany's. Germany has indeed been a locomotive for global demand.

DISSECTING AND EXPLAINING THE SURPLUS

Examining the current account in more depth illustrates my arguments further. Germany's trade surplus—the difference between exports and imports—has been relatively steady at 6 percent of GDP since the financial crisis, after rising strongly beforehand. But in recent years the composition of the trade surplus has shifted. Nowadays there is little surplus any more with the rest of Europe, as many more exports go to emerging economies. This reflects the shifting pattern of booms and crises—and not some form of German mercantilism as is sometimes suggested. The services balance, another important part of the current account and formerly in deficit, has also improved. Germany has become a more attractive tourist destination, with tourists heading to the beaches on the Baltic Sea and to its trendy capital, Berlin. Both of these, in fact, needed some time to catch up and develop after reunification and became appealing just as southern Europe was becoming expensive. But the services balance also reflects that exports and investment-related services have expanded—machines abroad need servicing, factories need managing.

Only 40 percent of Germany's surpluses are due to domestic factors.

In fact, the current account surplus has a lot to do with foreign investment by German firms. If they had invested at home (and not created jobs abroad), this would have partly shown up in imports and the current account surplus would have been smaller. But they invested abroad, buying machines and capital goods from Germany, which caused the current account surplus to increase. Is this bad for the world? Certainly not, but it might look so at first sight.

All that German FDI (the stock of which amounts to close to half of Germany's annual GDP by now) had a structural effect on current accounts: A growing pile of profits is being transferred back home (or reinvested, creating more jobs). It is true that some German money was lost in U.S. subprime mortgages, but better regulation in the banking union should help avoid this in the future. And this is far from a general pattern: German investment

abroad yielded a healthy 6 percent return in recent years, according to calculations by the Ministry of Finance in Berlin—not bad compared with the 5 percent foreign investment returned in Germany and a lot better than benchmark yields for government debt in Europe, Japan, or the United States.

Each euro of additional public spending would only result in 9 cents of higher import demand.

Finally, it is worth looking at the criticism that German investment at home is allegedly too weak. It is true that investment in construction has been weak (though this has spared us much of the bubble trouble). But investment in equipment in Germany is close to the international average and investment in research and development is very high by international standards. Germany could do more in infrastructure—which would reduce the surplus through a high import component—and there are indeed plans to do so via more private investment. But surely a careful approach is preferable to all the losses and distortions suffered elsewhere from poor-quality investment during the boom years. Germany would be foolish to reenact the mistakes others have come to deeply regret.

GERMAN SURPLUSES WILL BE ON A SINKING TRAJECTORY

What are the origins of such large surpluses? And are they likely to persist? German current account surpluses are undoubtedly large: about 7 percent of GDP or about €200 billion in 2013. If such figures were to persist for a very long time, concerns would arise whether so much money could indeed be wisely invested, not to mention the perception that this was a handy pot of money to bail out all those "in need." But to my mind there is little reason to worry.

First, I mentioned the policy reforms that strengthened Germany's competitiveness over the past ten to fifteen years. At the same time, some of our trading partners allowed import booms related to construction, expansionary fiscal policies, and excessive wage growth. As a result, local industries declined, imports from Germany rose, and exports to Germany declined. But the good news is that since 2009 this trend has been reversing within Europe. Crisis countries have been regaining competitiveness through wage moderation (as did Germany a decade earlier). They have brought their public finances in order, reducing much unproductive spending in the process (as did Germany a decade earlier). And they are strengthening banks and companies while the construction sector is shrinking (as did …). Exports are now increasing strongly in some of the former crisis countries, but it takes time to rebuild a strong tradable sector. The German surplus within the eurozone is already less than half of what it was in 2007. And, undoubtedly, we will see further corrections in the near future.

Yes, it is true that the common currency has slowed down this correction. The deutschmark would have appreciated far more than the euro has done since its inception (especially during the crisis). This helped German exporters and supported surpluses. But with our European partners reforming and regaining competitiveness and confidence in the euro rising, this factor will play less and less of a role.

The second factor is the rapid industrialization in emerging economies. Strong growth in Asia, notably China, but also in Latin America or the Middle East, has benefited Germany in particular. Machinery and equipment exports boomed; Mercedes, Audi, BMW, and Porsche are now global status symbols for the rich and famous and dominate the high-end car market. Other countries that used to have their strengths in markets in which the emerging economies are now competing in benefited less. But we now see emerging economies slowing. And it is not clear whether German exporters will remain on the winning side as emerging economies move up the value chains and produce cars instead of bicycles or machines instead of tools.

Third, Germany benefited from the growing role of international supply chains in reshaping trade patterns. According to the IMF, vertical specialization has been particularly evident among exporting firms in Germany.

Germany is the only major industrial country that has kept its global import share stable since the financial crisis.

German firms thus took more advantage of international labor cost differentials and qualification patterns than firms from other countries did.

A fourth factor pointing to a reduction in German surpluses is wage development. German wages are currently growing robustly in nominal and real terms. When matched against declining unit labor costs in the eurozone periphery, these increases are even more pronounced. Compared with Greece, German unit labor costs have appreciated more than 15 percent in real terms since 2007. This trend is not likely to end given rather tight labor markets in Germany and high unemployment elsewhere.

Therefore, I see good prospects for a significant decline in German surpluses over time. However, a turn into deficits is not likely: The IMF sees a surplus for Germany of about 2 percent to 5 percent of GDP as "normal" in the long term. High net foreign assets—all those German-owned factories abroad yielding sound profits—and one of the most rapidly aging populations putting money in the piggy bank for their retirement will keep Germany in surplus.

POLICY ADVICE TAKEN TO THE TEST

Unfortunately, most of the advice going round to reduce German surpluses is poor. Following it would help neither Germany nor anybody else. It would just make the world a less stable and prosperous place.

Some critics argue that Germany should raise domestic demand. Again, this is barking up the wrong tree. German growth is currently exclusively driven by domestic demand. Private consumption growth has accelerated to a rate of expansion that is much higher than the eurozone average. Imports are buoyant, as I mentioned above. The output gap is probably already closed, which means that "artificial" demand stimuli in Germany would be pro-cyclical and a waste of public money.

The current account surplus has a lot to do with foreign investment by German firms.

A similar picture emerges when dissecting the often-touted advice that Germany should simply raise wages. In fact, an analysis by the Bundesbank shows that only 40 percent of Germany's surpluses are due to domestic factors. And among them the effect of wage restraint has been negligible. By contrast, excessive wage growth in Germany would have a negative long-term impact on growth, employment, and imports. This, in turn, would create significant adverse repercussions on the rest of Europe and globally. For every euro Germany exports, around 25 cents are sourced abroad, according to research by German institute IfW. This figure is much smaller for imports intended to meet consumer demand.

Nowadays there is little surplus any more with the rest of Europe, as many more exports go to emerging economies.

Debt-financed public expenditure programs—another favorite policy suggestion to Berlin—do not fare better. According to the Bundesbank, each euro of additional public spending would only result in 9 cents of higher import demand. Deficit spending would raise public debt and reduce confidence in Germany, where sound public finances have strong public support. It would also weaken its role as the eurozone's anchor of stability and a role model for compliance to the eurozone's rules. *Honi soit qui mal y pense.*

A SENSIBLE AGENDA OF POLICIES

But what is there to do? First, Germany needs to maintain a sound and attractive business environment with sustainable public finances and healthy wage growth. This will underpin domestic demand. And it will underpin Germany's role as a strong partner for international economic specialization as well as the diffusion of capital and knowledge. This is the most significant benefit that Germany can continue to provide to itself and the world.

However, there is a to-do list for Germany to promote sustainable growth in the long run. Germany should continue with reforms to achieve a healthy and reasonably flexible labor market and avoid reversing past progress. This would also be beneficial for eurozone countries with high unemployment as it would create

Continued on page 72

Continued from page 53
job opportunities for immigrants (there is already very high net immigration from southern and eastern Europe to Germany at the moment).

Furthermore, Germany needs to improve its domestic investment climate and stimulate private investment. This is particularly important in different areas of infrastructure, such as telecommunications, energy, and transport. The current government is prioritizing these areas alongside more spending on child care, research, and education. This should not only stimulate growth, but also boost domestic demand via consumption and investment.

There are also major "do nots." If the economy is flourishing, it is more important to avoid complacency than anything else. Because it is then that demands for new social handouts proliferate—often with the best intentions. Incentives for longer rather than shorter work lives have become more of a priority than ever before.

With regard to Germany's international trading partners, they should see its exports as an opportunity to link up within vertical supply chains. Eastern European countries have successfully shown how to become a hub for the production of intermediate inputs. Ireland is another good case study for trade integration-led growth, not to mention many Asian countries.

Finally, regarding Europe, the economic reform process to regain competitiveness and fiscal and financial stability needs to continue. This also applies to countries elsewhere that have large deficits due to competitiveness problems and policy deficiencies and distortions. Not the continuation of reforms—as some claim—but giving up all that has been achieved via expansionary policies would be the real tragedy.

Germany would be foolish to reenact the mistakes others have come to deeply regret.

In sum, if policies are sound and undistorted, focusing on current accounts is not helpful. Germany certainly needs reforms but it should not appease misguided criticism of a strong international economic integration that benefits everybody. Calls for simple demand expansion will neither help the world nor countries in difficulties. Blame games will not help either. They are the sirens of quick fixes and distraction. Surely it is time that we move on from barking up the wrong tree. ◆