CAN GERMANY MAKE GLOBALIZATION WORK?

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Can Germany Make Globalization Work?

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Harold James[1]

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Executive Summary

It is often argued that Germany — perhaps with China – is left as the defender of globalization and an open commercial order, in the face of disarray in the international order, structural changes in the world economy, and even the possibility of an end or a reversal of globalization. But both countries are often said to be "cheating" in their approach to globalization. Germany has long sought to multilateralize its diplomacy, but has been more selective and more hesitant in its approach to international governance issues. Like China, Germany has many vulnerabilities. These include inflexible corporate governance, a bank-based financial model, the fading of the small- and medium-sized enterprise (*Mittelstand*) dream and problems of continuity in family businesses, a proclivity for incremental rather than fundamental technical innovation, ageing and demographic decline, and a more hostile international environment.

In order to continue to be a force for stability Germany needs to demonstrate that it is not cheating and should also show that it is "smart" as well as hardworking. That requires a skillful response to the modern vulnerabilities of globalization. Much of that response will require careful coordination — by governments, firms, and indeed individuals — on a European and international level. This paper suggests using global business linkages as a way of modernizing German corporate governance, developing fundamental research as a partial answer to security threats, acting collectively to solve migration issues, and taking a more active role in reforming European and global financial institutions through a move to more Europeanization and less insistence on national mandates and national representation.

1 Globalization and Its Vulnerabilities

Today the international order is in disarray. The old hegemon, the central player in the post-1945 world, the United States appears to be destroying the system that delivered widespread prosperity and growth. The inauguration of Donald Trump as the 45th president of the United States, Chinese President Xi Jinping's Davos defense of globalization, and the Koblenz "alternative European summit" with Marine Le Pen and Geert Wilders launched 2017 as the year in which the global order will be remade. Trump and his European would-be imitators denounced globalization, while Xi presented himself as its principal defender.

Trump's "America First" inauguration speech, with its conscious echo of the isolationist aviator Charles Lindbergh, was a renunciation of the whole history of Washington's role in making and sustaining the postwar order. The main objection to the past policy orientation was about the economic loss that American leadership inflicted on the American people. That is an old criticism. It has constantly been raised as an objection to "global America." But this is the first time that it has been enunciated by a president of the United States.

The main targets of Trump's inaugural speech were the "other countries," especially China and Germany, which got rich at the cost of the United States (although he would later complain that "We're taken advantage of by every nation in the world virtually. It's not gonna happen anymore.").[1] They run large bilateral trade surpluses with the United States — China's is by far the largest: a $347 billion bilateral deficit in 2016, with Germany narrowly in third place (after Japan) with $65 billion. Both are substantially lower than in 2015.[2] Just before the inauguration, Trump suggested high tariff levels on imported German cars, and in particular, singled out BMW. The accumulated current account surpluses (rising in the German case, while falling rapidly for China) mean that these countries have built up large claims on the United States — government debt in the case of China, and a wide variety of securitized assets in the case of Germany.

So Germany and China now see themselves cast, perhaps reluctantly and hesitantly, as the new defenders of a global order. China and Germany are increasingly aligned on climate change issues, where President Trump's emphasis on coal appears obstructive and destructive. There is a clear Chinese–German alliance building on resistance to trade protectionism as an exercise in locking oneself in a dark room, a Chinese phrase which Chancellor Angela Merkel singled out as "very memorable."[3] The Chinese president has been particularly forceful. Xi Jinping in Davos stated that:

> "From the historical perspective, economic globalization resulted from growing social productivity, and is a natural outcome of scientific and technological progress, not something created by any individuals or any countries. Economic globalization has powered global growth and facilitated

There is a clear Chinese–German alliance building on resistance to trade protectionism as an exercise in locking oneself in a dark room, a Chinese phrase which Chancellor Angela Merkel singled out as "very memorable."

[1] C. Weaver and J. Smyth, "'Don't worry' about tough phone calls, Trump tells Americans," *Financial Times*, February 3, 2017, https://www.ft.com/content/a3dcb988-e96b-11e6-893c-082c54a7f539.

[2] Bureau of Economic Analysis, "U.S. International Trade in Goods and Services December 2010," February 7, 2017, https://www.bea.gov/newsreleases/international/trade/2017/trad1216.htm.

[3] P. Donahue, "Merkel, Li Hail Trade Ties as Trump Pursues Protectionism," Bloomberg, January 26, 2017, https://www.bloomberg.com/politics/articles/2017-01-26/merkel-li-push-eu-china-trade-ties-as-trump-lauds-protectionism.

movement of goods and capital, advances in science, technology and civilization, and interactions among peoples."[4]

Large parts of the production process that were formerly contained in distinct national or corporate containers now spill over.

The clearest recent statement by the German Chancellor was in her budget speech on November 23, 2016, emphasizing that increasing globalization increased the need to act collectively, and that Germany could not on its own "fight the whole problem of worldwide hunger, solve the issue of 65 million refugees, or change political order everywhere in the sense that we would like." But she added that Germany should try to shape globalization in the light of its experience with the social market economy in a multilateral setting, and should not "withdraw." In particular, "the G20 was the attempt to shape globalization in a human way and to provide for a sensible financial and economic order with the largest and most important economic powers of the world."[5] German leaders too have started to make a case that Germany can promote globalization in the absence of a United States which is less engaged (as it is — and has been — a less open economy, because of its size).[6] "You can see the weight of our economic interests," Vice Chancellor Sigmar Gabriel argued. "Germany should act with self-confidence and not be fearful or servile. We are a highly successful, technologically advanced export nation with many hard-working people and smart companies."[7]

As Stefan Fröhlich has emphasized recently, Germany's position derives primarily from an economic logic, rather than political reflection.[8] The German position of today in regard to an interconnected world reflects a view that derives back to the 19th century on the centrality of economic forces, when the inventor of the term *Realpolitik*, Ludwig August von Rochau, wrote that "for Germans, unity is basically a pure business affair [*eine reine Geschäftssache*] in which no one wants to lose, but everyone wants to extract as much as possible for themselves," rather than a matter of the heart.[9]

The economics of modern globalization is driven by global value chains (GVCs) in which economic activities are divided up over long geographical distances, between countries and between companies: in other words, large parts of the production process that were formerly contained in distinct national or corporate containers now spill over. That is a force for disruption — Schumpeterian creative destruction — and sometimes promotes a nostalgia for a simpler past.

[4] Xi Jinping, "President Xi's speech to Davos in full," World Economic Forum, January 17, 2017, https://www.weforum.org/agenda/2017/01/full-text-of-xi-jinping-keynote-at-the-world-economic-forum.

[5] A. Merkel, "Budget speech of 23 November 2016," Die Bundesregierung, November 23, 2016, https://www.bundesregierung.de/Content/DE/Bulletin/2016/11/138-1-bkin-bt.html; jsessionid=E662DD61835F9BF54B7A7AC024CEA914.s5t1.

[6] See W. Jacoby and S. Meunier, "Europe and the Management of Globalization," *Journal of European Public Policy* Vol. 17.No. 3 (2010), pp. 299-317, http://www.tandfonline.com/doi/full/10.1080/13501761003662107.

[7] K. Stratmann and T. Sigmund, "Gabriel: Germany Should Face Trump with Self-Confidence," *Handelsblatt*, January 23, 2017, https://global.handelsblatt.com/politics/gabriel-germany-should-face-trump-with-self-confidence-688352; Reuters, "Trump's TPP Exit Gives Germany Economic Opportunity, Says Vice Chancellor Gabriel," January 23, 2017, http://www.newsweek.com/donald-trump-germany-tpp-trans-pacific-partnership-trade-547137.

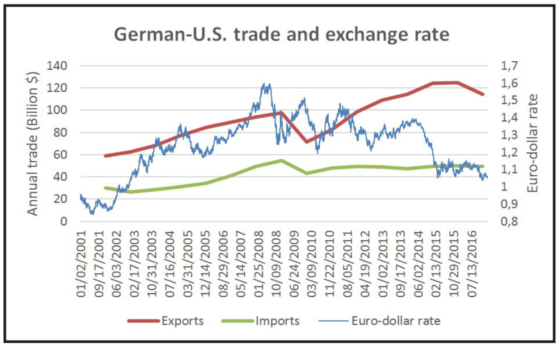
[8] S. Fröhlich, "Berlin's New Pragmatism in an Era of Radical Uncertainty," Transatlantic Academy, January 2017, http://www.gmfus.org/publications/leadership-partnership-berlins-new-pragmatism-era-radical-uncertainty, p. 1.

[9] L.A. von Rochau, *Grundsätze der Realpolitik II*, (Heidelberg: J.C.B. Mohr, 1869), p. 26.

Does globalization generate more inequality, and hence more social dislocation and political tension? There is a great deal of evidence that the more complex a country's products, the greater equality it has relative to similar-sized economies.[10] Germany and Japan, as complex manufacturers with complex productive structures that reflect a high level of social capital, have lower levels of inequality than countries with more unbalanced production structures.

The peculiarity of the potential Germany–China axis is that the new possible leaders are in important ways flawed. Both are widely suspected of "cheating" in order to win the globalization game. It is not just the view of President Trump that China cheated by holding down its exchange rate for a long time, until 2015, as well as by giving subsidies and restricting foreign access to the ownership of Chinese businesses. For American critics, Germany also managed to manipulate its exchange rate by agreeing first on a hard European exchange rate system from 1979, then, after 1999, by locking it into the euro, and then finally, after the financial crisis, by encouraging euro depreciation. In consequence, Trump thinks of the European Union, and the monetary union, as simply a mechanism to protect German interests and extend German power, an "instrument" of Germany.[11] And a prominent former International Monetary Fund (IMF) official, Ashok Mody, similarly but rather strangely describes the IMF as an "instrument" of Germany in the euro crisis.[12] So multilateralism and multilateral institutions often have to take the rap for Germany. This frequent American criticism is misplaced. German exports to the United States surged in the early stages of the recovery from the financial crisis, when the euro was very strong, and then stagnated and fell as the euro weakened quickly against the dollar after May 2014. In other words, we see again that price is not essential to this sort of competition (see chart).

German exports to the United States surged in the early stages of the recovery from the financial crisis, when the euro was very strong, and then stagnated and fell as the euro weakened quickly against the dollar after May 2014.



It is a question of consumer choice. Take an example from clothing to see what the issues in the eurozone involve. Unlike a Chinese or Mexican or Guatemalan T-shirt, no one is likely to buy a Hugo Boss (German-made) or Canali (Italian-made) suit because they are cheap. Indeed, being cheap would destroy the brand image. But an Italian manufacturer may face problems because of worries about higher future taxes due to Italian fiscal issues, or because they cannot have good access to credit, and those constraints might interfere in their ability to continue to deliver technically advanced and stylish products. The people who make high

[10] D. Hartmann, M.R. Guevara, C. Jara-Figueroa, M. Aristarán, and C.A. Hidalgo, "Linking Economic Complexity, Institutions, and Income Inequality," *World Development*, January 2017, http://www.sciencedirect.com/science/article/pii/S0305750X15309876.

[11] M. Gove and K. Diekmann, "Full transcript of interview with Donald Trump," *The Times*, January 16, 2017, http://www.thetimes.co.uk/article/full-transcript-of-interviewwith-donald-trump-5d39sr09d.

[12] A. Mody, "The IMF Should Get Out of Greece," Bloomberg, February 3, 2017, https://www.bloomberg.com/view/articles/2017-02-03/the-imf-should-get-out-of-greece.

Protectionism may disrupt the global supply chains that are at the heart of a great part of modern manufacturing — including Germany's business model.

quality products, whether in Italy or Germany, are usually proud of their craftsmanship, and they should be. Does that mean that they have a dangerous nationalism in their hearts?[13] In order to be effective, producers certainly need some pride, but they also require a benign fiscal and credit environment — in every country.

The globalization model is vulnerable because of responses to trade, to technical innovation, as well as anxieties about the flow of people (producing cultural and security concerns, as well as a direct economic challenge to competing workers). In particular, protectionism may disrupt the global supply chains that are at the heart of a great part of modern manufacturing — including Germany's business model.

The anxiety about trade wars escalating grew in the aftermath of the global financial crisis. The WTO documented cases of trade-restrictive measures, including trade remedies, for G20 economies. The rate of application is increasing, and of the 1,583 recorded cases since 2008, only 387 had been removed (May 2016).[14] Trade levels fell very steeply in 2008-09 (until April 2009, the rate of decline was faster even than during the Great Depression). But then there was a recovery that stalled, and world trade then began falling in nominal terms after October 2014.[15]

[13] As alleged by Walter Russell Mead, W.R. Mead, "The Real Trade Challenge Is Germany, Not China," *The American Interest*, March 6, 2016, http://www.the-american-interest.com/2017/03/06/the-real-trade-challenge-is-germany-not-china/.

[14] World Trade Organization, "Report on G20 Trade Measures," June 21, 2016, https://www.wto.org/english/news_e/news16_e/g20_wto_report_june16_e.pdf.

[15] S. Evenett and J. Fritz, "The tide turns? Falling world trade and the G20," VoxEU.org, November 12, 2015, http://voxeu.org/article/protectionism-and-fall-world-trade.

As trade restrictions become widespread, attention turns to the exchange rate as an instrument of trade policy — as occurred in the mid-1980s, and (much more seriously) in the Great Depression of the 1930s. In particular, there is a likelihood that the package of measures promised by Trump as a means of reviving the U.S. economy, fiscal stimulus as well as levies on trade (the border adjustment tax), will lead to an appreciation of the U.S. dollar, making foreign, including European, products cheaper and intensifying U.S. concerns about dumping. Peter Navarro, the new head of the National Trade Council, has spoken of bilateral negotiations to "rebalance" U.S. trade with Germany, seemingly ignoring the problem that trade issues are negotiated by the EU rather than by member countries.[16] The linkages between trade and exchange rates were a central element of attempts at international cooperation in the past, in the Bretton Woods conference of 1944 as well as in the G5/G7 Finance Ministers meetings of 1985-87 (from the Plaza meeting to the Louvre).

After 2015 and a surge of refugees into the EU (mostly to just two countries with relatively dynamic and flexible economies, Germany and Sweden), anxiety about immigration drove the rise of populist parties across the EU, and Trump's campaign repeatedly held up German immigration policy as the key European mistake.

[16] R. Rao, "The Morning Ledger: White House Wants Partners to Buy American to Reduce Trade Deficit," *The Wall Street Journal*, March 10, 2017, http://blogs.wsj.com/cfo/2017/03/10/the-morning-ledger-white-house-wants-partners-to-buy-american-to-reduce-trade-deficit-newsletter-draft/. See also D. Ikenson, "Peter Navarro, Harvard PhD Economist, Trade Warrior," Cato Institute, March 7, 2017, https://www.cato.org/blog/peter-navarro-harvard-phd-economist-trade-warrior.

The challenges raise the issue of how flows of trade and capital and people should be managed.

In order to continue to be a force for stability Germany needs to demonstrate that it is not cheating and needs to show that it is “smart” as well as hardworking. That requires a skillful response to the modern vulnerabilities of globalization.

2 Germany and the International Economic Order: A Brief History

Germany has always looked for solutions, but with a vital proviso: any solution that deviated from profound national interests — in the German case the pursuit of a stability-focused policy — would stand no chance of ultimate success.

Germany has always had a commitment to the principle of multilateralism in international relations, in large part because the development of the export-driven postwar economy was intertwined with and dependent on institutions which liberalized the international (global) as well as the European trading order.[17] Indeed, the idea of working through international organizations, rather than directly asserting national interests directly at the negotiating table, is often termed *Genscherismus* or Genscherism, after the late great and long-serving Foreign Minister Hans Dietrich Genscher. Genscherism applied particularly in the area of security, in NATO, the OSCE, but also in the EU. The foundations of the approach are both the weakness of Germany as a security presence (economic giant but political dwarf), and, more importantly, an internalization of the responsibilities and limitations imposed by the legacy of the Nazi past. A consequence was that there always appeared to be an odd quality in which interests were asserted in a veiled or camouflaged way, using the language of multilateralism. But that does not of course mean that the commitment to multilateralism is inherently insincere: it is the fact that it is perceived to serve Germany's interests that provides a deep foundation for the policy.

Germany has also been a consistently central, albeit somewhat idiosyncratic, voice in debates about the international financial and economic system. The G7 process, both at the finance minister and head of government levels, goes back to a proposal that Helmut Schmidt developed with his friend Valéry Giscard d'Estaing, when both were finance ministers, for an informal exchange of views, with the first meeting in the White House Library. Germany has also always looked for solutions, but with a vital proviso: any solution that deviated from profound national interests — in the German case the pursuit of a stability-focused policy — would stand no chance of ultimate success. In particular, Germany for obvious reasons has been anxious about those moments when summit meetings — most notably in Bonn in 1978 or the G20 meeting in Seoul in 2010 — focused on action by large surplus countries to reduce their surpluses. In Seoul, Berlin seemed to coordinate its blocking of a U.S. initiative to limit current account surpluses to 4 percent of GDP with Beijing. But Germany, like China, has recently worked toward a holistic approach to the summit process, and in particular integrate environmental and sustainability concerns into the economic discussions. The G7 summit in Schloss Elmau in June 2015 with the slogan "Think Ahead. Act Together." looked like a spectacular moment of coordination in the face of multiple crises, including the security crisis in Ukraine, and a reassertion of the importance for successful and sustainable and inclusive democratic politics of thinking ahead and meeting future as well as present challenges.

A further consistent element of the German approach to the international financial architecture is the government's respect of the position of the fiercely autonomous central bank, the Deutsche Bundesbank, even though that has been since 1999 no longer a real central bank but a part of the Eurosystem and in effect a branch of the European Central Bank (ECB).

[17] See H.C. Wallich, *Mainsprings of the German Revival* (New Haven: Yale University Press, 1955); C. Buchheim, *Die Wiedereingliederung Westdeutschlands in der Weltwirtschaft, 1945-1958* (Munich: Oldenburg, 1990).

The most long-lasting element in Germany's toolset for the international arena is the idea that the German proposals should not be nationally specific, but require to be placed in a general European context. That is not only a constitutional requirement stated in the preamble to the Basic Law. After the 1990 unification, Article 23, which had allowed the accession of the East German *Länder*, was modified so as to state (paragraph 1):

> "With a view to establishing a united Europe, the Federal Republic of Germany shall participate in the development of the European Union that is committed to democratic, social and federal principles, to the rule of law, and to the principle of subsidiarity, and that guarantees a level of protection of basic rights essentially comparable to that afforded by this Basic Law."[18]

The powerful and highly respected German institutions, the Constitutional Court and the Bundesbank, both acknowledge this as a limitation on their room for maneuver.

Germany's Contribution to the System

The first great moment of German assertiveness in the international financial system occurred in the later stages of the Bretton Woods system, especially in the later 1960s, as Germany increasingly built up trade surpluses that reflected a favorable development of productivity gains as well as the containment of wage costs through a collaborative and collective approach to wage setting. Trade surpluses would become the hallmark of late 20th century German-style capitalism. By contrast, deficits in Germany's trade partners reflected either lower innovation or (especially in late 1960s France and Italy) a less disciplined approach to wages in an era of full employment and increased social and political radicalism (reflected in large numbers of days lost in strikes). In the era of fixed exchange rates and controlled capital markets, even relatively small deficits could not be financed, and produced immediate pressure on the exchange markets. The deficit countries then had to apply fiscal brakes in a so-called "stop-go" cycle. Germany's partners, notably France, were faced with the prospect of austerity and deflation in order to correct deficits. This alternative was unattractive to the French political elite, because it constrained growth and guaranteed electoral unpopularity. Their preferred policy alternative was thus German expansion, but this course was unpopular with a German public worried about the legacy of inflation and was opposed by the powerful and independent central bank, the Deutsche Bundesbank. Solving the question of the German current accounts in the European setting at first appeared to require some sophisticated political mechanism, and also public debate, that would force French politicians to do more austerity than they would have liked, and Germans less price orthodoxy than they thought they needed. That was the aim that was eventually realized in the Maastricht Treaty.

Solving the question of the German current accounts in the European setting at first appeared to require some sophisticated political mechanism, and also public debate, that would force French politicians to do more austerity than they would have liked, and Germans less price orthodoxy than they thought they needed.

Germany took a step that could be viewed both as the destruction of the existing Bretton Woods system or as a necessary step to reform, when German actions were in large part the trigger of President Nixon's dramatic August 1971 decision to end the gold convertibility of

[18] See Grundgesetz für die Bundesrepublik Deutschland, Art. 23, e.g. via https://www.bundestag.de/parlament/aufgaben/rechtsgrundlagen/grundgesetz/gg_02/245124.

The European Monetary System was designed to be accompanied by a European Monetary Fund, but that was never realized, in large part because of the opposition of the Bundesbank.

the dollar. Germany faced a massive inflow of dollars, and looked initially for international solutions — either a wider European fluctuation band or international pressure on the United States to tighten its loose monetary policy — but achieved no results. On May 10, 1971, Germany embarked on a unilateral float that led to a revaluation of the Deutschemark — a goal sought also by the United States, which was much less successful in pressing Japan to revalue. The German decision thus made possible the negotiation of a new set of exchange rates at the Smithsonian monetary conference in December 1971. When further large capital inflows into Germany occurred, in 1973, Germany responded this time by organizing a joint European float against the dollar.

The second great wave of German institutional contribution to the design of the international monetary system came in the late 1970s, at a time of dollar weakness when many critics feared that the United States was pursuing a policy of "malign neglect." Helmut Schmidt explicitly envisaged the creation of the European Monetary System as an answer to U.S.-induced policy uncertainty. He saw a European Unit of Account as a new reserve unit that would "take the pressure off the dollar."

In a striking appearance before the Bundesbank Council on November 30, 1978, when Schmidt tried to persuade a reluctant Bundesbank, he denounced the tendency to think of appropriate economic and monetary policy in purely national terms: "There are bad exaggerations around when each views it through national spectacles. One side prattles about an inflationary community, the others, English and Italians in particular, prattle about a deflationary community which would be accomplished there and would disrupt their whole national economy." The European Monetary System was designed to be accompanied by a European Monetary Fund, but that was never realized, in large part because of the opposition of the Bundesbank.

Schmidt also referred to the more fundamental dilemmas of German foreign policy:

> "We are doubly vulnerable and will remain so far into the next century. Vulnerable on account of Berlin and also on account of the open flank to the East, on account of the partition of the nation, symbolized by the insular position of Berlin, and secondly we remain vulnerable on account of Auschwitz. The more successful we are in the areas of foreign policy, economic policy, socio-economic matters, and military matters, the longer it will be until Auschwitz sinks into history. So much the more we remain reliant on these two pillars, of which I spoke, one of which is the Common Market. A European Community without an efficiently functioning common economic market will decay."[19]

Germany, steered by the Bundesbank, has often been skeptical of expansionary reform initiatives in the international monetary system, especially when it concerned a new role for the SDR (the IMF's Special Drawing Right,

[19] Deutsche Bundesbank archive N2/269, December 1, 1978, Emminger to Schmidt, with verbal protocol of central bank council meeting. It has been translated into English by the Margaret Thatcher Foundation: "Transcript of meeting of the Bundesbank Council, 30 Nov 1978," www.margaretthatcher.org/document/111554. See in general on this issue H. James, *Making the European Monetary Union* (Cambridge, Mass.: Harvard University Press, 2012).

devised in the 1960s to deal with the issue of uncertainty about the role of the dollar in providing world liquidity). By contrast, China has often expressed interest in extending the role of the SDR, based on a basket of currencies that since 2016 includes the renminbi). In 1992, at the IMF/World Bank meetings in Madrid, it was largely German resistance that blocked an initiative by the IMF's managing director to proceed to a new SDR issue in the light of demands from emerging and transition countries. At the height of the euro crisis, Angela Merkel resisted a proposal, developed by France, at the Cannes summit for a use of the SDR in the international system that would also involve the use of the SDR to address the European debt issue. In particular the Bundesbank, which represented Germany on the IMF's Governing Body, was opposed to the use of foreign reserves to solve fiscal issues and termed such action financial "trickery." Merkel made it clear that she would not override the Bundesbank on this issue. The question was unanswered of why the Bundesbank, or indeed Germany – should be represented at the IMF on this issue and whether it would not be more logical if the European Union were to be treated as a large single shareholder of the IMF, in the same way as the EU and not the members states is represented in the WTO.

There is a need to apply Helmut Schmidt's insights of the 1970s on the global stage. However, the source of vulnerability has changed. Germany is no longer exposed because of the division of Germany or simply European problems but because of global developments and challenges.

3 The German Model and Its Weaknesses

In the wake of Chancellor Gerhard Schröder's reform agenda of the 2000s, and specifically its labor market reform, Germany has cast itself as a model for other European countries.

Since the 1970s, Germany has often presented itself as Modell Deutschland, a phrase first popularized and promoted by Helmut Schmidt. In the wake of Chancellor Gerhard Schröder's reform agenda of the 2000s, and specifically its labor market reform, Germany has cast itself as a model for other European countries. Indeed, some parts of the German model have been cited as examples by political leaders who might not at first sight have been expected to be sympathetic. French President Nicolas Sarkozy argued that Germany prioritized "jobs, jobs, jobs. If it worked for them, why wouldn't it work for us?"[20] Theresa May's first policy speech as U.K. prime minister evoked German industrial relations — including worker representation on company boards — as a template for how the U.K. might move to more inclusive and more balanced growth. Donald Trump emphasized how the United States should try to make itself more like the German economy — by which he meant a large share of manufacturing in economic activity.

But the German model has some considerable weaknesses, which reinforce each other in a network of path-dependent restraints:

1. Corporate Governance

The arrangements that tied major companies, banks and politicians together in long-term relationships are often styled Deutschland AG (or *Deutschland Aktiengesellschaft*, Germany as a joint stock company). The banks held company stock, and with politicians and labor leaders sat on the boards of companies. But that rather cozy arrangement was challenged in the 1990s, by European integration, the creation of a single European capital market and then a single money, and by globalization. Long-term commitments and personal relationships were now replaced by a short-term transactional view of how capitalism operated, which held the opportunity of substantially increased profits. The iconic firms around which modern industrial Germany had been built took a knock in the new environment, as their shortcuts to increased profitability unraveled publicly and humiliatingly. Siemens spent years recovering from a bribery and corruption scandal. ThyssenKrupp was shaken by the revelations of price-fixing in a rail-track cartel. Even Lufthansa's reputation for safety was damaged after a copilot with a history of mental troubles steered a jet into a mountainside. Most seriously, the revelation of manipulated diesel emissions of Volkswagen cars rocked the image of Germany's auto industry, and the resulting legal costs as the company is sued by governments, customers, dealers, and ordinary citizens will hurt its bottom line. The VW example is also an indication of how the German experience pushes for technological continuities that can be costly (see point 4).

2. Bank-based Finance Governance

Dependence on banks rather than the capital market is also a feature of the German model that goes back to Imperial Germany and to the origins of Germany's emergence as a great economic power. But banks have been at the center of Europe's vulnerability in the European debt crisis. Germany's particular problems lie in the three-tiered banking system, where there are substantial vulnerabilities in both public and private banks (the third sector, credit cooperatives, is more robust). Like European banks more generally, the German

[20] *The Economist*, "What Germany Offers the World," April 14, 2012, http://www.economist.com/node/21552567.

banks demonstrated their vulnerability and in particular a dependence on dollar funding during the global financial crisis.[21]

Public sector local banks, *Sparkassen*, have a strong reputation in Germany and are popular with electors: they give better service, with lower fees, and more personal attention to retail customers. They are also at the heart of the *Mittelstand* economy. They are vulnerable in the face of attempts to devise a standard international approach to capital adequacy, and argue that they are less risky because they know their customers well, and hence should be allowed to hold lower capital buffers. In fact, there is considerable risk that arises out of the wholesale side of public sector banking.

The *Landesbanken*, the wholesale side of public sector banking, have been at the center of Germany's banking problems since the 1990s. In 2001, the European Commission deemed that unlimited guarantees from states to *Landesbanken* amounted to illegal state aid, but they continued to behave as if they had a public guarantee and consequently took on high risk activities. Their vulnerability showed in 1998, when they incurred large losses in the Asia crisis, and above all in the global financial crisis, when they were exposed as large-scale holders of U.S. sub-prime mortgage debt. Sachsen LB and WestLB failed, and the Berlin LB was put in the hands of the Berliner Sparkasse. There are currently only seven *Landesbanken* left, as four disappeared in the course of the financial crisis.

[21] Hyun Song Shin, "Global Banking Glut and Loan Risk Premium," Mundell-Fleming Lecture, *IMF Economic Review* 60 (2), 2012, https://www.imf.org/external/np/res/seminars/2011/arc/pdf/hss.pdf.

The large-scale private banks, which have tried to compete on the international stage, ran into major problems during the global financial crisis. Dresdner Bank, which had been bought by the insurer Allianz in 2002, was sold to Commerzbank in 2009. Commerzbank itself required state recapitalization in 2009. Deutsche Bank, the most typical, most representative, most prestigious, and largest German bank also made the strategic choice to become a global investment bank. That meant something quite different from the traditional relationship banking of the German past. The major landmarks were the acquisition of the London investment bank (merchant bank in English parlance) Morgan Grenfell in 1990, and then of Bankers Trust in New York in 1998. Chief Executive Joseph Ackermann's most notorious promise was a 25 percent pretax rate of return on equity, which was only achievable with the thinnest of thin capital ratios: Tier 1 capital was just 1.47 percent of assets at the end of 2007 (and even lower in 2008). It was vulnerable when dollar funding dried up and as the valuation of complex securities became an impossible task. Ackermann's successor, Anshu Jain, promised a "culture change" in 2012, but it was always rather unclear how the former star investment banker might realize that. The suspicion remained that Jain's promises of "a multi-year journey" to culture change was just an exercise in management jargon. In June 2015, Jain resigned after widespread discontent with his performance.

The Landesbanken, *the wholesale side of public sector banking, have been at the center of Germany's banking problems since the 1990s.*

3. The Mittelstand *Model*

The *Mittelstand* has been at the core of German success, with successful "pocket multinationals" that provide very focused goods for niche markets. Many of them are based in industrial

German policymakers share the anxiety about missing out on what they think of as the Fourth Industrial Revolution (Industrie 4.0).

districts, most notably in Baden-Württemberg and more recently in Bavaria and Thuringia, where there are clusters of similar businesses that draw on the same skilled workforce and can coordinate in marketing and sales. These businesses are often family firms (see point 5) and in some high profile cases succession crises lead to the sale of a business to foreign investors, with Chinese companies buying Putzmeister (concrete pumps) and Kiekert (car-door latches). Sometimes the buyers are also family firms, but sometimes — especially in large cases such as Krauss-Maffei (a large engineering company, specializing in automation and injection molding) it is state-owned enterprise, in this case the China National Chemical Corporation.[22]

The model of German business relied very heavily on family business. But the family business model is under another deep challenge, because of the change of family structures. Large scale family firms are often split by divisions between branches of the family and between the conflicted offspring of patchwork families. The Piech/Porsche clans and their disputes are one of the causes of the governance problems in VW. The Haniels and the Albrechts (of the Aldi discount grocery chain) have been damaged by divisions in which a high-spending younger generation clashes with the frugality of the past generations. The phenomenon is not new — it is in fact already presented in Thomas Mann's iconic novel on the rise and fall of a family firm, *Buddenbrooks* (1900).

4. Technology

Germany has a powerful engineering tradition, and is excellent at incremental changes, that makes for highly successful and competitive products in iconic areas such as engineering and automobiles (where Germany is absolutely dominant in the luxury sector). But it is poorer at radical innovation, where completely new businesses are invented. The German-born Peter Thiel on these grounds is very critical of German innovative capacity.[23] German policymakers share the anxiety about missing out on what they think of as the Fourth Industrial Revolution (Industrie 4.0). In 2014, Chancellor Merkel stated that "We have the opportunity for a digital economic miracle. The question is whether or not it will happen in Germany." The chief of staff in the Chancellery, Peter Altmaier, explained that: "In the future, 50-60 per cent of the value of a car will consist of digital devices and tools, and 20 percent of batteries. So if we're not careful, we'll only be responsible for the windows, seats, and wheels."[24]

5. Demography

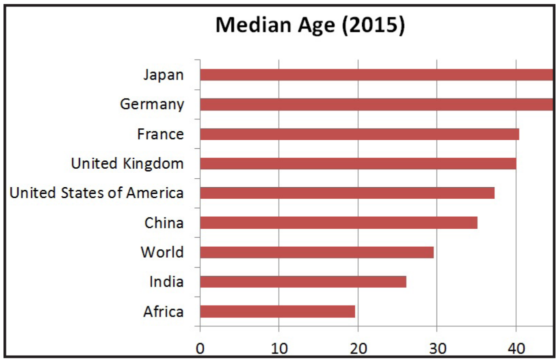
Germany's fertility rate is 1.4 children per woman, compared with 2 in France, 1.8 in the U.K. and an EU average of 1.6. The preference for single or no child families creates a significant demographic imbalance, with a rapidly ageing population worried about how its old age future will look (or be paid for); there are also vicious feedback loops in that older households don't want to spend on education rather than health

[22] K. Ulrich, "Chinese billions for German businesses," Deutsche Welle, January 13, 2016, http://www.dw.com/en/chinese-billions-for-german-businesses/a-18976032.

[23] P. Thiel, *Zero to One: Notes on Startups, or How to Build the Future* (New York: Crown Books, 2014).

[24] G. Chazan, "Why Germany needs to accelerate into the digital fast lane," *Financial Times*, January 25, 2017, https://www.ft.com/content/31469796-dcd1-11e6-9d7c-be108f1c1dce.

and care provisions for the old — although collectively, in their long term interest, they should. The demographic imbalance creates at the moment a need for high savings levels — the driver of the contentious current account imbalances. It also generates a need for more skilled immigration. Up until 2015, the skilled share of non-EU migration to Germany was rising appreciably (from a fifth in 2000 to two fifths by 2013). The surge of refugees and asylum seekers in 2015 lowered the skill mix appreciably, although 27 percent of Syrian asylum seekers in 2015 had university degrees.[25]



6. The Others' Responses

President Trump reached the conclusion that the globalization process did not work at all, because the surplus countries cheated. There are two alternative courses that the United States might take: one more conventional, the other so radical that it looks like the equivalent of a financial nuclear bomb. The soft alternative, of making bilateral deals, is the more plausible one: it also has some historical precedents. In the 1980s, Japan agreed to "voluntary" restrictions on Japanese cars sold in the United States. The consequence was that Japan stopped selling cheap cars and moved abruptly up the value chain.

But then there is the more radical option. Sometimes the Trump administration speaks about a defensive solidarity based on "Anglo-American capitalism."[26] Old style Anglo-American capitalism was about manufacturing. The new style is about the buildup of debt to maintain high levels of consumption and well-being, to push ideas of greatly extended home ownership. The essence of a Trumpian art of the deal approach might be to allow people but also countries to get out of debt more easily. The new president holds out a nationalistic version of what is often a radical left demand, the notion of a debt jubilee or write-off.

The attraction of this course is that debt can trigger an internal explosion in the surplus countries in the event of large scale defaults. The strategic thought might be to let China blow up because of its large levels of internal debt; and let the EU explode because of the unresolved debt issues within the eurozone. Some comments by individuals associated with the Trump administration — including Ted Malloch, tipped as the next U.S. ambassador to the EU — suggest that there is a deliberate

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[25] A. Rich, "Asylerstantragsteller in Deutschland im Jahr 2015: Sozialstruktur, Qualifikationsniveau und Berufstätigkeit," Bundesamt für Migration und Flüchtlinge (BAMF), May 2016, http://www.bamf.de/SharedDocs/Anlagen/DE/Publikationen/Kurzanalysen/kurzanalyse3_sozial-komponenten.pdf?__blob=publicationFile.

[26] C. Hope and B. Riley-Smith, "Donald Trump to meet Theresa May before any other foreign leader since his inauguration as new deal planned for Britain," *The Telegraph*, January 22, 2017, http://www.telegraph.co.uk/news/2017/01/21/donald-trump-plans-new-deal-britain-theresa-may-becomes-first/.

course to destroy the Union altogether.[27] Responding to that strategy requires a clear solution that diminishes the vulnerabilities: tackling the issue of non-performing loans in China, and ensuring that eurozone debt is sustainable — by write-offs of existing debt, linked with reforms to ensure that a new buildup of unsustainable public debt levels does not occur, and by adapting a clear and convincing growth strategy.

Germany faces numerous internal and external vulnerabilities. It is time to address the challenge of using the new surge in the extent of internal vulnerability in order to redress some of the old and long-standing internal problems.

[27] P. Foster, "Euro could 'collapse' in next 18 months, warns the man tipped as Trump's EU ambassador pick," *The Telegraph*, January 26, 2017, http://www.telegraph.co.uk/news/2017/01/26/euro-could-collapse-next-18-months-warns-man-tipped-trumps-eu/. Also W. Münchau, "How Europe Can Avoid Falling into America's Trade Trap," *Financial Times*, January 29, 2017, https://www.ft.com/content/137cc610-e4b8-11e6-8405-9e5580d6e5fb.

4 Solutions

How can Germany make globalization work? Some of the challenges are deep-rooted: it is particularly hard to see any likelihood of change in the demographic regime. But there is a scope for adjusting Germany's institutional response, and here internationalization — or globalization — offers a chance of breaking out of idiosyncrasies that make Germany vulnerable. The answers are mostly European and not peculiarly German — and in that sense they underline the extent to which the stability of German prospects are predicated on a stable but also more dynamic Europe. A broad-based response — on the level of technology, on a role for government on a European level in public-private partnerships, and also on international governance reform — is required.

1. The Globalization and Enterprise Challenge

What Hans-Werner Sinn criticized as the "bazaar economy," with large German imports of partly manufactured goods for further processing/assembling as the cause of a "pathological export boom,"[28] is in fact a strategic advantage that links Germany not just to a central European hinterland, but to many countries throughout the world. At the beginning of the modern wave of globalization in the late 20th century, an influential management consultant, Kenichi Ohmae, set out the new philosophy of globalized business enterprise based on ability to respond to the needs and preferences of customers.[29] Europe became the exploratory laboratory of globalization. It has been moving toward market integration since the 1950s, first with a common external tariff and the abolition of internal tariffs, and then with a coordinated move to a Single Market by 1992 (and a common money by 1999). The creation of the single market was also accompanied by a number of high profile cross-border mergers. Competition law has effectively become Europeanized, and the European Commission has turned into an effective enforcer of controls on monopolistic enterprise (notably in the Google and Rosneft cases), but also in attacking European cartel arrangements. The vision behind this approach should also work on a global level — no longer simply on a European level. GVCs represent a way of harnessing technology effectively. The technical imperatives also mean stripping away layers of traditional corporate governance that in the past obstructed technical change and innovation.

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2. The Security Challenge

The uncertain international environment pushes Europe to think more in terms of security cooperation. A complaint of Trump's — articulated many times by U.S. policymakers going back as far as the 1960s — is that Europe has been free-riding on the U.S. security umbrella, and not spending enough on defense. The demand for more European defense coordination is legitimate. This area is one where there are many benefits from coordination, although that has usually been

[28] H. Sinn, *Die Basar-Ökonomie. Deutschland: Exportweltmeister oder Schlusslicht?* (Econ Verlag: Berlin, 2005); H. Sinn, K. Sauernheimer, T. Seidel, R. Ackermann, M. Pflüger, N. Piper, J. Hahlen, P. Bernholz, and M. Schmid, "Der pathologische Exportboom These und Stellungnahmen," ifo Schnelldienst 59 (01), 2006, http://www.cesifo-group.de/portal/page/portal/DocBase_Content/ZS/ZS-ifo_Schnelldienst/zs-sd-2006/ifosd_2006_1_k.pdf, pp. 3-32.

[29] K. Ohmae, "Managing in a Borderless World," *Harvard Business Review*, May–June 1989, https://hbr.org/1989/05/managing-in-a-borderless-world.

Military security, cyber security, energy security: these are areas where Europe should take an example from the great era of American success in the late 20th century.

blocked by national defense interests which want to maintain the national market for over-priced products.

In particular, an up-to-date view of security involves thinking about new forms of defense — in particular against cyberwar, including financial sabotage dislocation but also the manipulation or distortion of news. Old-fashioned armies are hardly the way to respond to all the multiple security challenges. What is needed is a European counterpart of the U.S. Defense Advanced Research Projects Agency (DARPA), created by President Eisenhower as a way of promoting fundamental research that would address future military challenges in a unconventional way by pushing research that the private sector on its own would not conduct. DARPA has been a key driver of the development of Silicon Valley. The now ubiquitous Apple Siri developed out of research into artificial intelligence. The origins of the ability to process big data — in companies such as Palantir — started with the U.S. intelligence community. In general, defense spillovers created a powerful motor for economic growth. So historically low European defense expenditure may have been an economic drag, rather than a cause of greater European prosperity. The discomfort of high-ranking academic and research institutions in the United States and the U.K. in the aftermath of the Trump election and the Brexit vote, and their implications for immigration policy, offer the EU a chance to establish Europe as a global leader.

A response to the financial and debt crisis, which is also a crisis of European growth, is to demand higher levels of investment — both public and private — in Europe. The problem is that in the past, much public sector investment has been misdirected as a result of the political bargaining processes. However, private investment has also been misdirected (above all in large construction booms). Military security, cyber security, energy security: these are areas where Europe should take an example from the great era of American success in the late 20th century. They all require coordination, and private-public partnerships.

Security has been at the heart of the process of building states. Even large European states are not well placed to handle security considered in its broadest sense. The more Europe is aware of its insecurity, the greater the chance is that it takes up the challenge. Collective security means providing an existence for its citizens that is resilient against disruption. It creates safety through the mobilization of new ways of processing information.

3. The Migration Challenge

The idea of technology and business and supply ties that link Europe and other parts of the world also brings a potential for political stabilization, which is essential to a lasting solution of the migration issue. Germany — again in partnership with EU members — needs to secure a stable development of North Africa and the Middle East, but also of countries beyond that immediate region whose weak economic and demographic profile means that they are the source of uncontrolled migration flows. One of the key features of China's globalization initiative has been infrastructure investment throughout the non-industrial world; and this is a course that Germany might think about, but in a different manner. Some — preferably the largest part — of the stabilization effort can be achieved by private sector initiatives, but there is a requirement for coordination, political assurance, and some strategic public investment that may largely be managed through existing multilateral agencies, both European (European Investment Bank) and international (World Bank).

4. The Governance Challenge

The governance system of international institutions is a legacy of the remaking of international order after World War II, but requires an overhaul to meet changing conditions — including the rise of GVCs and the linkage between economic instability, migration flows, and political destabilization. A critical issue is the governance and legitimacy of international institutions. The problem of European over-representation at the IMF and the World Bank has been an agenda issue for decades, not just since the 2008 financial crisis. But the legacy of the global financial crisis makes the issue more urgent. So does the Trump presidency, which in many ways pushes the EU and China much closer together. This cooperation requires a more secure institutional foundation. To quote Xi Jinping in Davos 2017: "Inadequate global economic governance makes it difficult to adapt to new developments in the global economy. Madame Christine Lagarde recently told me that emerging markets and developing countries already contribute to 80 percent of the growth of the global economy." The EU should quickly consolidate its quotas at the Bretton Woods institutions and have a single representative. One old dilemma here has been removed by Brexit. The U.K. always raised the issue of whether it was the eurozone or the EU that should be represented; the distinction is less relevant for the EU27, as all are either in the eurozone, or committed to join the euro, or in the sole case of Denmark not committed but operating with a fixed peg against the euro.

It might be that the single chair at the Bretton Woods institution should be taken by the long-debated European Monetary Fund.[30] The EMF would also be expected to play a role in future European crisis management, obviating the need for a complex interaction between the IMF and single members of a common currency. There is a revived interest, including notably a German government proposal, on the development of the rescue mechanism of the European Stability Mechanism into a European Monetary Fund that would be independent of the Commission and its politics.[31] The EMF is a neat solution to the previously problematic question of who should represent Europe if there were a single IMF and World Bank seat, since the ECB as a central bank is not really suited, and many Europeans would worry about giving new powers to the European Commission.

The EMF is a neat solution to the previously problematic question of who should represent Europe if there were a single IMF and World Bank seat, since the ECB as a central bank is not really suited, and many Europeans would worry about giving new powers to the European Commission.

A parallel reform might involve rethinking the role of the ECB, and its relationship to the traditions of the Bundesbank. The overall goal of monetary stability is still vital, but it needs to be realized in a new way that thinks of Europe as a whole. There is a strong case for moving away from the principle of national representation which produces the outcome — deeply resented in Germany — that Malta or Slovenia's vote is as weighty in the ECB

[30] For an earlier discussion, see G. Corsetti and H. James, "Why Europe needs its own IMF," *Financial Times*, March 8, 2010, https://www.ft.com/content/c4853732-2ab4-11df-b7d7-00144feabdc0.

[31] *Der Spiegel*, "Europäischer Währungsfonds soll IWF ersetzen," February 24, 2017, http://www.spiegel.de/wirtschaft/soziales/europaeischer-waehrungsfonds-soll-iwf-bei-euro-krisen-ersetzen-a-1136143.html.

Council as Germany's. A system of regional representation analogous to that of the Federal Reserve System, where some states are even in different Reserve districts, would be a way of formulating a common European monetary policy. It might be thinkable that southern Germany (Bavaria and Baden-Württemberg) have a similar business structure with many small internationalized firms as northern Italy and they could be grouped together in a single ECB "district."

German prosperity and influence are linked, and they are also tied in to European and global developments. Like China, Germany cannot make globalization work on its own, and needs to work in a multilateral setting. Germany — like many successful but much smaller countries such as Singapore, Sweden, Switzerland — would be a principal loser from a retreat from globalization. It needs the technology — the GVCs — but also the political infrastructure to make globalization work, in Europe and in the world.

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