



SURPLUS GERMANY

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Cover photo: German Finance Minister Wolfgang Schäuble, Chancellor Angela Merkel, and Transport and Digital Infrastructure Minister Alexander Dobrindt confer, December 2016.
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WADE JACOBY

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EXECUTIVE SUMMARY

Many countries want Germany to change its economic policies. For all its differences with the Obama administration, the Trump White House has reiterated U.S. concerns about Germany's very large current account surplus, now in its fifteenth year and exceeding 8 percent of German GDP. Both administrations have worried that Germany's surplus hurts the U.S. economy. Neither has successfully convinced German leadership a serious problem exists. In this, they join a long line of European officials who have sought changes in German policy.

For its part, German leadership has honed two complementary rhetorical techniques to deal with such charges. The first is to characterize trade outcomes — whether their large surplus or other countries' deficits — as a simple matter of differences in competitiveness. The second is to manage any objections with a technique I call “normalize and apologize.” That is, officials prefer to stress that the German economy is basically just like any other advanced economy and that its competitiveness is available to any state willing to do the right policy reforms. When pushed to acknowledge that Germany enjoys unique benefits or when asked to change policies that negatively affect Germany's partners, officials then become apologists, articulating and defending Germany's uniqueness and purported inability to change.

This policy paper first discusses the Obama and Trump administrations' concerns on the German surplus. It acknowledges that the U.S.-German bilateral trade balance should not be the issue (but rather Germany's overall current account surplus in the global economy). And it distances itself from the idea that Germany's gains come from “currency manipulation.” At the same time, the paper uses the European

debate about similar kinds of imbalances to cast significant doubt on the competitiveness explanation favored by German officials. It turns out that competitive differences — which do exist across countries — are themselves a product of large financial flows. This is a hard to understand and therefore underappreciated facet of the trade debate. Trade balances are not driven simply by “high quality at low prices,” as the Germans like to say. They are driven also — and often much more — by financial flows that reflect policy-driven changes in incomes, consumption, savings, and investment. Of the three usual sources of growth — consumption, investment, and trade — Germany has grown disruptively reliant on the latter and has used policy instruments that tend to restrict the other two. This is what must change.

Once these underlying mechanisms are brought more clearly into view — the task of the latter part of this paper — Germany's “normalize and apologize” tactics ought to become much harder to defend. German public officials generally do not understand these dynamics and so are genuinely puzzled when confronted with them. Even those who recognize Germany's savings surplus tend not to link it to disruptive effects abroad. Germany's most important official economic institutions — including the Bundesbank — often resist discussing the financial-cum-trade dynamics, choosing instead to enable the “normalize and apologize” tactics of non-economists. Thus, Germany's “man on the street” and its woman in the Chancellery share the same misguided diagnosis.

In policy terms, the diagnosis is clear: the government urgently needs to reduce taxes on labor and consumption (such as value-added

tax), take a much more aggressive stance that moves public investment from the low end of the Organisation for Economic Co-operation and Development (OECD) to the higher end, and find ways either to reduce soaring national savings rates or improve the investment climate for firms or both. Special investment funds — such as that already envisioned for transportation — might also be established for schools and hospitals. Minimum pensions could be established. Investments in refugee training, housing, and medical care could be enhanced substantially, and Germany could more aggressively take the lead in European-wide initiatives in defense, refugee integration, border protection, and research and development. Germany's fiscal situation would likely worsen, as has the fiscal situation of every country obliged or inclined to accept savings inflows in excess of what can be profitably invested.

This is a hard message for German politicians to hear in an election year. It's also a hard message to deliver: if Germany's friends are too blunt, they risk being ignored. If they're not blunt enough, they risk being misheard. While the policy menu is flexible, the core message is not: the dynamics of financial flows are extremely powerful and disruptive. Germany can normalize and apologize to its trading partners for only so long. At some point, the world will be unable to absorb its capital surpluses (and those of several other countries). Another painful correction will follow, during which the preservation of the liberal international order cannot be assured. As a surplus country, Germany is highly vulnerable to an erosion of the liberal order. In that sense, change — however difficult — is in Germany's core interest.

1 INTRODUCTION

“Everything should be made as simple as possible. But not simpler.” –Albert Einstein

In mid-April, longtime German Finance Minister Wolfgang Schäuble’s visit to Washington, DC during the annual spring meetings of the International Monetary Fund and World Bank provided another occasion for the now-ritualized U.S.–German conversation about trade imbalances. As detailed below, Germany has sold far more goods than it imports for about a decade and a half. In recent years, Germany’s trade partners in Europe and the United States have expressed concern that these surpluses partly reflect policy distortions in the German domestic economy, a diagnosis German officials have sought to rebut and reject.

In his prepared remarks in Washington, Schäuble stressed the need for fiscal rectitude in all states, rebranding Germany’s well-known insistence on fiscal orthodoxy as a form of “resilience.” Schäuble also stressed recent German increases in domestic consumption and public investment, conveniently leaving out that these increases would be from levels at or near the bottom of the Organisation for Economic Co-operation and Development (OECD) rankings in both categories.¹ The veteran politician understood these “increases” would be music to the ears of many American listeners — after all, persistently low consumption and investment shares make the German economy overly reliant on foreign demand and further boost Germany’s huge trade surplus.

By mentioning Germany’s “effective public redistribution” and “no-cost education systems,” the finance minister deftly side-stepped the country’s rapidly-growing inequality, including in education. This inequality is another driver of Germany’s recent export mania, since household purchasing power has weakened across much of German society (40 percent of Germans have essentially no net wealth at all).² In interviews in Washington, Schäuble castigated Germany’s critics as ill-informed for not recognizing recent real wage increases or the role of the weak euro, as if marginal or cyclical factors can explain (or resolve) a major structural condition of the international economy.³ After all, Germany’s trade surplus certainly is higher when the euro falls close to the dollar, but it was also plenty high when the euro was at \$1.50.⁴ And for reasons we’ll get to shortly, a few years of modest German real wage increases, while useful, are far from sufficient to correct Germany’s trade imbalance.

Against this backdrop, this policy paper explains why German trade patterns reflect policy choices and not simply market outcomes (as German elites persistently maintain). These policies are supported by a particular policy discourse — which I call “normalize and apologize” — that mostly manages to satisfy its supporters and still mollify (or, at least, befuddle) its critics. The next section argues

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¹ W. Schäuble, “International Monetary and Financial Committee Statement,” April 22, 2017, <http://www.imf.org/External/spring/2017/imfc/statement/eng/deu.pdf>, pp. 2-4.

² M. Fratzscher, *Verteilungskampf: Warum Deutschland immer ungleicher wird* (Munich: Carl Hanser Verlag, 2016).

³ CNBC, “CNBC Exclusive: CNBC Transcript: German Finance Minister Wolfgang Schäuble Speaks with CNBC’s Michelle Caruso-Cabrera Today,” April 20, 2017, <http://www.cnbc.com/2017/04/20/cnbc-exclusive-cnbc-transcript-german-finance-minister-wolfgang-schauble-speaks-with-cnbc-michelle-caruso-cabrera-today.html>.

⁴ Similarly, the surplus has also been extremely high with oil at \$40 a barrel — but was still plenty high with oil at \$110 a barrel in 2014.

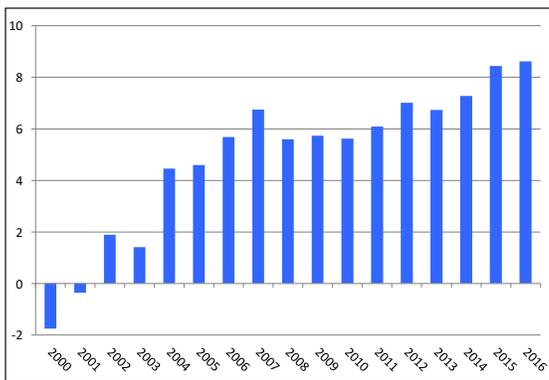
that Germany's trade surplus has now stretched the apologist's ability and the apologee's credulity to their limits, thus accounting for the warning shots fired by the U.S. legislative and executive branches in recent years.⁵ The final two sections seek to get beyond the two sides' dueling inanities ("raise wages"/"make better cars") and foreground a more complex story highlighting the surprising and powerful effects of capital flows to help explain both the intra-European and transatlantic trade disputes. Too many core participants in the debate seem not to understand these capital dynamics, which result mainly from a steep climb in German savings rates and a stagnation in German private and public investment. The conclusion sketches the options the German and American leaders might consider going forward, if the debate were to be made "as simple as possible, but not simpler."

⁵ And picked up on by the Finance Ministry. See L. Schuknecht, "Schäubles Chefvolkswirt verteidigt deutschen Exportüberschuss," *Frankfurter Allgemeine Zeitung*, February 23, 2017, <http://www.faz.net/aktuell/wirtschaft/wirtschaftspolitik/exportueberschuss-von-deutschland-wird-stark-kritisiert-14890840.html>.

2 THE U.S.-GERMAN TRADE STALEMATE: FROM OBAMA TO TRUMP

Since the election of Donald Trump, an important unknown in transatlantic relations was whether the new president would lump Germany with states like China and Mexico whose export success he saw as a threat to American prosperity. Would there really be a trade battle, and would it involve America's close ally, Germany? We are still waiting to find out, but the potential is certainly there. As Figure 1 shows, Germany's current account moved from negative territory — where it had been through much of German reunification — into large surpluses by 2004.⁶ Those surpluses have now grown to over 8 percent of German GDP. But to what extent is this a problem?

Figure 1: German Current Account (% of GDP)



Source: Eurostat

⁶ Technically, the current account is more than just trade. It is a country's net balance in traded goods and services, net income on its overseas investments, and net "transfers" (things like remittances, grants, or tax payments that have no quid pro quo). Of these components, however, the trade portion is, by far, the largest. The trade account also closely approximates Germany's current account since the other components (small deficits in trade in services and remittances and a small surplus in secondary income) usually balance each other out.

The Obama administration decided it was and placed intermittent pressure on Germany to reduce these surpluses. This aim intersected with Congressional pressure on countries with large and sustained trade surpluses with the United States and found expression in Treasury Department reports that named Germany as one of six countries of concern. Obama-era worries about German policy comingled with complementary worries about Germany's central role in managing the long eurozone crisis after 2010, particularly German preferences for austerity and structural reforms to the near-exclusion of demand-side features.⁷

Alongside these concerns about German policy and preferences, however, the Obama team nurtured a very close relationship with Germany.⁸ As the indispensability of that partnership became more clear, U.S. grouching about German economic policy took on the character of ritualized nagging in which Washington continued to make the case for a change in German policy but where that case was not allowed to intrude into a very productive relationship in other areas. These areas included reforming financial regulation, dealing with climate change, and building a sanctions regime against Russia.

On the campaign trail during 2015 and 2016, Trump had seemed both more and less worried about Germany than Obama had been. On

⁷ J. Furman, "The New View of Fiscal Policy and Its Application," as delivered at the Conference on "Global Implications of Europe's Redesign," New York, NY, October 5, 2016.

⁸ F. Bozo, S. Fröhlich, W. Jacoby, H. James, M. Kimmage, H. Kundnani, Y. Mounk, T. Reinert, M. E. Sarotte, S. F. Szabo, and H. Tworek, "Suspicious Minds: U.S.-German Relations in the Trump Era," Transatlantic Academy, May 2017, <http://www.gmfus.org/publications/new-report-trump-administration-must-cooperate-europe-germany-needs-creatively-boost>.

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trade, Trump had made surpluses vis-à-vis the United States into a central part of his economic message. And while he saved his strongest rhetoric for China and Mexico, it was clear that other countries with persistent surpluses — South Korea, Japan, Taiwan, Germany — might spark concern. But in general, Germany arose rarely in the campaign, and the main impression was that Trump thought Chancellor Angela Merkel was doing an admirable job, aside from his observation that her refugee policy was “insane.”⁹

An inauguration-week interview with *The Times* of London and the German tabloid *Bild* (daily circulation: 2.5 million) at first seemed to herald a shift. While Trump seemed to signal that German export surpluses with the United States were not as large a concern as those of China, he still suggested German firms could face 35 percent tariffs on products built in, say, Mexico and imported to the United States.¹⁰ He noted the presence of Mercedes cars in front of “every house on Fifth Avenue” and lamented the lack of Chevys in front of German houses. Trump advisor Peter Navarro, director of the new White House National Trade Council, later referred to Germany as using a “grossly undervalued euro” to “exploit” the United States and other trade partners.¹¹ Moreover, if

Trump’s goal is more balanced trade accounts, the presidency has powerful legal instruments to pursue that goal.¹²

In a way, the *Bild* interview encapsulated perfectly the stalemate of the Obama years: Trump, consciously or not, was echoing the longstanding U.S. charge that German firms depend too much on external consumption and that the German economy provides too little consumption to benefit others. This time, it was left to Germany’s foreign minister, Social Democrat Sigmar Gabriel (on his first day in office), to deliver Germany’s equally ritualized response: America should “build better cars,” he told *The Guardian*.¹³ Germany’s Christian Democrats have often delivered the same message, both to the United States and to any of Germany’s European partners with similar concerns about German trade surpluses.¹⁴

Subsequent weeks, however, have seen the immediate threat to Germany appear to fade. Most importantly, the March bilateral meetings between Trump and Merkel (and concurrent ministerial meetings in preparation for the July 2017 G-20 summit hosted by Germany) indicated that the United States was not inclined to prioritize its trade imbalance complaints with Germany. If anything, the Treasury Department’s semiannual report to Congress

⁹ John Dickerson interview with Trump, see CBS News, “Face the Nation Transcripts October 11, 2015: Trump, Carson,” October 11, 2015, <http://www.cbsnews.com/news/face-the-nation-transcripts-october-11-2015-trump-carson>.

¹⁰ 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-interview-with-donald-trump-5d39sr09d>.

¹¹ S. Donnan, “Trump’s top trade adviser accuses Germany of currency exploitation,” *Financial Times*, January 31, 2017, <https://www.ft.com/content/57f104d2-e742-11e6-893c-082c54a7f539>.

¹² M. Noland, G. C. Hufbauer, S. Robinson, and T. Moran, “Assessing Trade Agendas in the US Presidential Campaign,” Peterson Institute for International Economics, September 2016, <https://piie.com/publications/piie-briefings/assessing-trade-agendas-us-presidential-campaign>.

¹³ P. Oltermann and A. Luhn, “Germany hits back at Trump criticism of refugee policy and BMW tariff threat,” *The Guardian*, January 16, 2017, <https://www.theguardian.com/world/2017/jan/16/germany-hits-back-at-trump-criticism-of-refugee-policy-and-bmw-tariff-threat>.

¹⁴ See e.g., Schäuble, “International Monetary and Financial Committee Statement,” 2017.

(see below) had a somewhat softer tone than that of last fall. Instead, the Trump team seems to have prioritized “renegotiating” the North American Free Trade Agreement (NAFTA) as the lead item on its trade agenda.¹⁵

It is, therefore, possible Germany will be spared a real confrontation over its trade surplus. But the wiser course would be for Germany to assume it has a window of opportunity to consider whether its Obama-era explanations for the trade surplus will work with the new U.S. administration. After all, there is a lot at stake in getting it right for a security-exposed, trade-dependent status quo power like Germany. To date, Germany has made things too simple by highlighting the undoubted high quality of its products as its preferred explanation for the surplus. This is unconvincing. German engineering has always been excellent, so this cannot explain how the country’s firms suddenly built a massive surplus. But neither can the surplus be fixed by raising German manufacturing wages, at least not alone, for changes in wages were only part of the issue in the first place.

More generally, both Germany’s defenders and its critics are overly focused on a microeconomic logic of competitiveness. While far from irrelevant, this logic is mediated and often dominated by less obvious, more counterintuitive macroeconomic dynamics. Put broadly, any national economy in an open international order has three primary sources of growth: domestic consumption, domestic investment, and net trade. The case against

Germany is that because it now has both low consumption and low investment, it has come to depend on exports for growth.

This, too, is not entirely new. Post-WWII Germany has always used an export-led growth model, and yet the resulting surpluses were generally low (often under 1 percent of GDP) with surges short-lived (e.g., the late 1980s). What has changed, subtly but surely, are Germany’s demographics, Germany’s wage and wealth distribution, and a number of its policies in the labor, welfare, and fiscal domains. Germany got much older — among major economies, only Japan and Italy are similarly aged — and it now has far more inequality than it used to.¹⁶ Both factors lead to even higher national savings than normal, and both factors also depressed investment. Since extra savings not used domestically are, by definition, exported, this shifts demand abroad, which is reflected in a trade surplus.¹⁷ The introduction of the euro exacerbated these trends. Moreover, Germany also raised taxes on consumption, cut taxes on business and constitutionalized balanced budgets. These choices further depressed domestic incomes and/or increased

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¹⁵ K. Liptak and D. Merica, “Trump agrees ‘not to terminate NAFTA at this time,’” CNN, April 27, 2017, <http://www.cnn.com/2017/04/26/politics/trump-nafta>.

¹⁶ Fratzscher, *Verteilungskampf*.

¹⁷ Excellent introductions to these dynamics are M. Pettis, *The Great Rebalancing: Trade, Conflict, and the Perilous Road Ahead for the World Economy* (Princeton, New Jersey: Princeton University Press, 2013) and E. Jones, “Shifting the focus: The new political economy of macroeconomic imbalances,” *SAIS Review*, 29(2), (2009), pp. 61-73. Econometric studies that show the relative contributions of savings and competitiveness in German trade patterns include R. Kollmann, M. Ratto, W. Roeger, J. in’t Veld, and L. Vogel, “European economy: What drives the German current account? And how does it affect other EU member states?,” European Commission Report, *Economic Papers*, vol. 516, April 2014, http://ec.europa.eu/economy_finance/publications/economic_paper/2014/ecp516_en.htm.

reliance on demand from abroad. The result is a country that leans very hard on external demand.

Before developing that argument more fully later in the paper, I first explain why the stalemate over German trade has been so durable. German officials generally stop short of calling American complaints outright illegitimate (e.g., “what part of free trade don’t you understand?”), while implying they are the natural and inevitable outcome of market forces. This is a technique perfected during the long battle over the causes and remedies of the eurozone crisis, a debate that is instructive for the style of argumentation that developed. More specifically, German officials have learned to speak as if all of Germany’s advantages are either the result of structural reforms — and so available to any state that makes similar choices — or unique institutional (e.g., debt brakes) or ideational (e.g., “ordoliberalism”) factors — and so cannot be changed. I call this Germany’s “normalize-apologize” discourse.¹⁸

¹⁸ “Apologize” is meant in the sense of “apologist,” someone who explains away apparently damaging evidence.

3

GERMANY'S "NORMALIZE-APOLOGIZE" DISCOURSE

In my dozens of discussions on this topic with German diplomats, interest group representatives, civil servants, journalists, and academics, certain patterns emerge that go beyond specific arguments. In this composite picture, German officials have perfected the art of mixing two very different messages. The first is that the German economy is basically just like any other advanced economy, and the second is that the German economy is singular, with its own logic and rules. There is a strong tendency to normalize Germany's economic strengths, suggesting they are simply a more competent version of what every other country does or should do. When pushed to acknowledge that Germany enjoys benefits others do not or when asked to change policies that may have negative effects on Germany's partners, officials then become apologists, articulating and defending Germany's purported inability to change.

This pattern goes well beyond the U.S.–Germany dispute over trade. For example, when critics of German policy call attention to the way the euro crisis ultimately made German debt service much more affordable or how the weak euro helped German exports boom or how Germany's wage restraint in the early 2000s boosted its later competitiveness, German officials stress the normality of Germany and say that these acknowledged advantages are available to any other country that undertakes the necessary supply-side reforms to earn them. This message plays well with the German media and voters.

But when outsiders ask Germany to change, for example, tax or investment policies that depress domestic demand, making Germany reliant on external demand, then singular Germany is emphasized. Apologists argue that

Germany cannot increase domestic investment because the state has an unusually small role in investment or has recently constitutionalized debt brakes that further limit its fiscal space or has a set of ordoliberal beliefs that amount to prohibitions on certain policy actions or even "sticky" consumption levels that don't respond to increased household income. To be sure, many states defend policy on grounds of uniqueness. Japanese trade officials once resisted American agricultural imports on the grounds that American beef wasn't right for Japanese intestines.¹⁹ And every state has particular institutions integral to its economic success that it might wisely wish to protect from the grinding homogenization of global competition.²⁰

Yet Germany's apologists are particularly industrious, and their rhetoric goes well beyond protecting unique national institutions. On demographics, for example, they argue Germany's low birth rate, high dependency ratios, and aging population lead to weak long-term growth prospects and thus naturally dampen domestic investment. Germany, in this view, has no choice but to lean on demand elsewhere: its aging population needs to save for impending retirement, and these savings naturally are invested abroad, where returns

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¹⁹ C. Haberman, "Japanese are special types, they explain," *The New York Times*, March 6, 1988, <http://www.nytimes.com/1988/03/06/weekinreview/the-world-japanese-are-special-types-they-explain.html>.

²⁰ R. Bronk and W. Jacoby, "Uncertainty and the Dangers of Monocultures in Regulation, Analysis and Practice," Max Planck Working Paper 16/6, March 2016, <http://eprints.lse.ac.uk/66562>.

are higher.²¹ In this view, countries with more favorable demographics have an obligation to run high trade deficits. It is implied that someday in the future when Germans decide to have babies again, Germany fully intends to return the favor and do its part for international consumption smoothing. In the meantime, its trading partners should either not worry about trade deficits or engage in structural reforms to improve their own economies (which brings us back to normalization).

This normalize-apologize technique is endlessly flexible, but the basic argument remains the same: Germany's strong performance is the result of its boringly normal behavior, while its intransigence in the face of outsiders' calls for change is the result of a national eccentricity that obliges path dependence and prevents change. My point in this fairly stylized overview is that these arguments work in Germany and for Germany not because they are right or wrong but because they keep the discussion focused on an essentially microeconomic logic of firm-cum-national competitiveness, which simply dominates the debate.²² It seems as if any combination of good and bad arguments is acceptable so long as the focus doesn't shift to balance sheet dynamics that are both harder to understand and tell a more problematic story.

²¹ To be sure, there are doubters. Hans-Werner Sinn worries that intra-EU debt in the TARGET2 system won't be repaid, which would follow on German foreign losses in the "dot com" and subprime crashes. H. Sinn "Es ist ungesund," *Die Zeit*, November 14, 2013, <http://www.zeit.de/2013/47/hans-werner-sinn-export-euro-rettung>; see also G. Schnabl, "Why Trump is Right," *Handelsblatt Global*, March 10, 2017, <https://global.handelsblatt.com/our-magazine/why-trump-is-right-722479>.

²² M. Matthijs and K. McNamara, "The Euro Crisis' Theory Effect: Northern Saints, Southern Sinners, and the Demise of the Eurobond," *Journal of European Integration* no. 2 (2015): 229-246, <http://www.tandfonline.com/doi/abs/10.1080/07036337.2014.990137?journalCode=geui20>.

4 BROKEN EQUILIBRIUM

Of all the eccentricities German apologists have had to explain, none is more vexing to its commercial partners than the very large current account surplus already mentioned. In the post-Bretton Woods world of flexible exchange rates, a country's trade balance is *supposed* to move up and down in a roughly systematic fashion. Broadly speaking, the main reason for this has to do with changes in the value of its currency. When a country exports more than it imports, there is a growth in the demand for its currency. After all, if others are to buy more of the exporting country's products, foreigners will first need more of its currency to make those purchases. Their demand for the exporter's currency will tend to push up the currency's price, and this will have the effect of making those exports more expensive and also making foreign goods a bit cheaper and, therefore, more attractive for the exporter's citizens to buy. In theory, the joint effect of all this is to restore trade to a rough balance.²³ Put differently, trade flows, like elevators, must go down and well as up.

And here is where Germany's partners are scratching their heads. For, in recent years, Germany's exports appear to only go up. In particular, the size of the goods surplus has jumped substantially after 2003 (see Figure 1). Why no downwards adjustment? A central factor is that because Germany is in a currency union, there is no mechanism strong enough to put downward pressure on their national trade balance. The market signals from Germany's large surplus are drowned out by stronger mechanisms that push the euro lower, including quantitative easing, low interest rates,

and struggling eurozone economies. With this important feedback linkage now impaired or broken, German exports can boom and yet the euro falls still further, leading to even more exports. The low euro means Germany is not alone in running a trade surplus. Thus, even France and struggling Italy are running large (> \$20 billion) annual goods trade surpluses with the United States.

However, German exports do stand apart in the European context. They have become large, unbalanced, sustained, and, increasingly, global. This can be encapsulated with what I like to call the story of the "four halves." First, exports account for roughly *half* of Germany's GDP (the OECD average is just under 30 percent). Second, this large volume of exports is also not generally balanced by imports. The extreme case is with the United States — Germany's leading market in 2015 — where only about *half* of Germany's exports were covered by imports from its trading partner. Third, necessarily coincident with the strong trade surplus is high investment flows abroad, where Germany's accumulated net investment position is now about *half* of German GDP. That is, Germans have decided to invest more while consumption has dropped sharply, and they disproportionately invest abroad rather than at home. Finally, while about *half* of German exports go to other EU member states, the other half goes out to the rest of the world, meaning that German trade surpluses are now a global phenomenon. Thus, these surpluses are large, unbalanced, sustained, and global. Moreover, deflationary adjustments in the eurozone have pushed crisis-hit states from current account deficits to balance or surplus. The result is that

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²³ To be sure, with increased global capital mobility, this exchange rate adjustment mechanism has clearly weakened as many more factors affect currency values.

In 2015, the U.S. Congress passed a Trade Facilitation and Trade Enforcement Act that called for closer monitoring of America's trading partners.

the eurozone, which used to be in a rough trade balance with the rest of the world, now runs a current account surplus of about 3.4 percent.²⁴

All this helps explain why it did not take a Trump victory for the United States to grow skeptical of large increases in its current account deficit. Alongside a spate of domestic causes, U.S. officials also looked abroad for relief. In 2015, the U.S. Congress passed a Trade Facilitation and Trade Enforcement Act that called for closer monitoring of America's trading partners. Section 701 of the Act obliged the administration to report to Congress on any trade partners that: 1) had a significant bilateral trade surplus with the United States, later defined as at least \$20 billion; 2) had a current account surplus of more than 3 percent of GDP; and 3) engaged in "persistent one-sided intervention in the foreign exchange market."²⁵

Germany is one of six economies (along with China, Japan, South Korea, Taiwan, and Switzerland) that have met at least two of these criteria (none has yet been judged to meet all three). In Germany's case, the trade surplus with the United States and the material current account surplus have been cited in all three semi-annual reports issued so far (including one under the Trump administration). The existence of a European single currency raises the issue of whether Germany could, even in principle, be found in violation of the third criteria. It appears that the answer is yes: "For

the purposes of Section 701 of the 2015 Act, policies of the ECB [European Central Bank], which holds responsibility for monetary policy for the euro area, will be assessed as the monetary authority of individual euro area countries."²⁶ That said, the ECB has not intervened substantially on foreign exchange markets since its coordinated effort to do so after the 2011 Japanese earthquake.

Yet the ECB has many other levers that affect currency values, and the U.S. statue could open the way for the new administration to choose a different metric than widespread euro sales. With the euro and dollar at near-parity, Germany has to feel somewhat vulnerable on this issue. Indeed, even the Obama team made clear that the criteria are subject to interpretation according to "circumstances."²⁷ Thus, Navarro's "exploitation" comments represent an escalation of tensions long in place, and even the more measured comments of other Trump administration officials should not lull German officials into a false sense of security. Instead, experts on both sides of the Atlantic should take account of two sophisticated conversations that bear directly on the tensions over the German current account surplus.

²⁴ See "Euro Area Current Account" at Trading Economics: <http://www.tradingeconomics.com/euro-area/current-account>.

²⁵ U.S. Department of the Treasury Office of International Affairs, "Report to Congress: Foreign Exchange Policies of Major Trading Partners of the United States," October 14, 2016, [https://www.treasury.gov/resource-center/international/exchange-rate-policies/Documents/2016-10-14%20\(Fall%202016%20FX%20Report\)%20FINAL.PDF](https://www.treasury.gov/resource-center/international/exchange-rate-policies/Documents/2016-10-14%20(Fall%202016%20FX%20Report)%20FINAL.PDF), p. 1.

²⁶ Treasury, "Report to Congress," p. 5.

²⁷ Treasury, "Report to Congress," p. 37.

5 REVISITING THE EUROPEAN DEBATE ABOUT GERMAN WAGES

First, these escalating U.S.-German tensions run alongside a debate that is lesser known in the United States but part of the long-running debate on the crisis of the euro. There, too, German surpluses have been seen as problematic.²⁸ There, too, German officials have sharply rejected the charge. The most widely supported version of that answer is that countries like Greece, Italy, Spain, and Portugal made their own problems: they lost control of their public spending, and they ruined their labor markets with loose wages and tight rules. The only fix is to reverse — however painfully — both the fiscal and competitive errors. To seek in Germany the fundamental causes of Southern Europe's trouble (or the core solutions to them) is a mistake.

Yet German discourse here often violates Einstein's famous principle that "everything should be made as simple as possible, but not simpler." German officials tend to posit the crudest versions of their critics' position and then label them crude, feeding the media's popular "virtuous Germany" framing for its economic reporting. Two oversimplifications are particularly pernicious. First, German officials often compare a state's fiscal situation to a household that must always balance its budget — never mind that states don't incur debt for similar reasons, service it in remotely similar ways, or even need to pay it all off (as households do). State fiscal situations in the early 2000s tell us little about their levels of economic misery post-2008, as fiscally virtuous

Spain and Ireland ended up with massive levels of public debt from bailing their banking systems.²⁹

A second analogy is between the national trade "competitiveness" and the competitiveness of an individual firm. If firms must strive for competitiveness, why shouldn't states do the same?³⁰ For example, Bundesbank President Jens Weidmann has likened any call for Germany to address its current account surplus to trying to "improve professional soccer by weighing down the players with backpacks."³¹ Of course these "rectitude and competitiveness" slogans are just the public face of more complex judgments, and yet even more complex and detailed accounts foreground the same basic points.³²

So are German officials making this too simple? Does the German current account surplus really cause problems for others? The debate now raging *outside* the EU has long been asked *inside* the EU. And that debate has been more interesting, finding that the German current account surplus *is* indeed a problem for its

Does the German current account surplus really cause problems for others? The debate now raging outside the EU has long been asked inside the EU.

²⁸ E. Jones, "Financial Markets Matter more than Fiscal Institutions for the Success of the Euro," *The International Spectator* no. 4 (2016), <http://www.tandfonline.com/doi/abs/10.1080/03932729.2016.1224699?journalCode=rspe20>.

²⁹ M. Blyth, *Austerity: The History of a Dangerous Idea*, (Oxford: Oxford University Press, 2013); R. Baldwin et. al., "Rebooting the Eurozone: Step 1 – Agreeing a Crisis narrative," VoxEU, November 20, 2015, <http://voxeu.org/article/ez-crisis-consensus-narrative>.

³⁰ For more on this error, see H. Flassbeck and C. Lapvitsas, "Wage moderation and productivity in Europe," Institute for New Economic Thinking, January 28, 2016, <https://www.ineteconomics.org/perspectives/blog/wage-moderation-and-productivity-in-europe>.

³¹ C. Jones, "Bundesbank president attacks Angela Merkel's policies," *Financial Times*, March 13, 2014, <https://www.ft.com/content/72fa600e-aa9e-11e3-9fd6-00144feab7de>.

³² Deutsche Bundesbank, "German balance of payments in 2015: Monthly Report," March 2016, https://www.bundesbank.de/Redaktion/EN/Downloads/Publications/Monthly_Report_Articles/2016/2016_03_balance.pdf?__blob=publicationFile, pp. 37-56.

The Volkswagen scandal notwithstanding, Germany has always made good cars (and good machine tools). Yet the country never saw export surpluses like these until recently.

trading partners but *not* in the way most often asserted. Instead, German trade flows are a symptom — not really a cause — of disruptive trends in the global economy that include Germany but also go well beyond Germany. In order to get to that point, however, we must start with the European version of the “competitiveness” debate being re-run in the U.S.-German relationship today. When we do, we see that the German claim that their success is driven mostly by their national competitiveness is something of a red herring. In other words, “making better cars” is neither how Germany really built these surpluses nor how the United States can reverse them. The Volkswagen scandal notwithstanding, Germany has always made good cars (and good machine tools). Yet the country never saw export surpluses like these until recently. Thus, there must be more factors than strong products and weak euros.

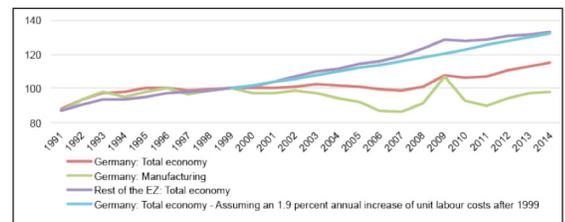
To get the bigger picture, let’s step back and consider a primary complaint in Europe since the onset of the crisis: that German public policy — especially the Hartz reforms of the early 2000s, which loosened labor regulations and cut social programs — led to a big cost advantage for German export firms that helped them outcompete firms in the crisis countries of Southern Europe.³³ One implication is that if Germany forced up costs for its exporting firms — hence the “backpacks” analogy — the South would recover faster, and Germany’s current account surplus would shrink again. This line, ironically, attacks Germany by turning the German defense on its head: if structural

³³ A. Johnston, B. Hancké, and S. Pant, “Comparative Institutional Advantage in the European Sovereign Debt Crisis,” The London School of Economics and Political Science: LSE ‘Europe in Question’ Discussion Paper Series, September 2013, <http://www.lse.ac.uk/europeanInstitute/LEQS%20Discussion%20Paper%20Series/LEQSPaper66.pdf>.

reforms explain German success, perhaps that’s because they went *too far* in lowering German costs.

German unit labor costs clearly have remained below those of its eurozone competitors. Figure 2 shows German economist Peter Bofinger’s calculations of compensation per employee. German wages begin diverging from the creation of the eurozone and these divergences are greater for manufacturing (green line) than for the total economy (red line). Figures like this play prominent roles in many criticisms of the German current account.³⁴ German officials tend not to emphasize German wage discipline, but when confronted with productivity differences, generally characterized the rest of the eurozone as insufficiently disciplined and in need of further structural reforms.³⁵

Figure 2: Unit Labor Costs per Employee (1999=100)



Source: M. Blyth, *Austerity: The History of a Dangerous Idea*, (Oxford: Oxford University Press, 2013); R. Baldwin et. al., “Rebooting the Eurozone: Step 1 – Agreeing a Crisis narrative,” VoxEU, November 20, 2015, <http://voxeu.org/article/ez-crisis-consensus-narrative>.

³⁴ B. Hancké, *Unions, Central Banks and the EMU*, (Oxford: Oxford University Press, 2013).

³⁵ See e.g., Schäuble, “International Monetary and Financial Committee Statement,” 2017, pp. 2-3.

Many critics, by contrast, argue that if Germany raised wages, its cost advantage and much of its current account surplus would then disappear.³⁶ However, four problems justify caution with the idea that Germany could make a significant contribution to the European economy (and, by extension, the global economy) if it would simply boost wages above productivity gains plus inflation.

First, there is a *category* problem with the “lost competitiveness” argument. In fact, Southern Europe in the mid-2000s suffered current account deficits not because of export declines (which might result from losing competitiveness) but from import booms financed by sharply increased lending originating around the onset of the eurozone.³⁷ The data from the pre-crisis period clearly show that Southern exports actually increased throughout the period (albeit much slower than imports).³⁸

Second, there is a *timing* problem with the diagnosis. A debt-led growth boom in Southern Europe *preceded* both higher imports and higher capital inflows, which then tightened local labor markets and *later* raised wages above productivity levels.³⁹ Thus, rather than labor

market deterioration causing macroeconomic problems, the situation was more the reverse: cheap capital flooded into Southern Europe and stimulated boom conditions, which then tightened labor markets, particularly in the sheltered public sector where unions were stronger.⁴⁰ The implication is that higher wages and inflation in Germany may not help Southern Europe recover faster.

Third, shifting from causes to implications, there is a *magnitude* problem: even if German wages now went up, this may not necessarily raise German export prices and thus narrow Germany’s competitive advantage. After all, labor costs are only roughly a fifth of overall firm costs, and some estimates suggest manufacturers pass on only half of increased wage costs to customers.⁴¹ Moreover, even if German wages rose, German workers are still about 10 percent more efficient than the eurozone average, so German firms can afford to pay more without necessarily losing market share. Finally, Germany’s specialized and high tech exports are not very price sensitive; Germany’s exports are mostly driven by the “income effect” of purchasers.⁴²

A debt-led growth boom in Southern Europe preceded both higher imports and higher capital inflows, which then tightened local labor markets and later raised wages above productivity levels.

³⁶ Flassbeck and Lapavitsas, “Wage Moderation and Productivity in Europe.”

³⁷ E. Jones, “Competitiveness and the European Financial Crisis,” in J. Caporaso and M. Rhodes, *The Political and Economic Dynamics of the Eurozone Crisis* (Oxford: Oxford University Press, 2016), pp. 79-99.

³⁸ S. Storm, “What is Missing in Flassbeck & Lapavitsas,” Institute for New Economic Thinking, February 22, 2016, <https://www.ineteconomics.org/perspectives/blog/what-is-missing-in-flassbeck-lapavitsas>.

³⁹ H. Gabrisch and K. Staehr, “The Euro Plus Pact: Cost Competitiveness and External Capital Flows in the EU countries,” European Central Bank: Working Paper Series, March 2014, <https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1650.pdf>.

⁴⁰ A. O’Connell, “European Crisis: A New Tale of Center-Periphery Relations in the World of Financial Liberalization/Globalization?,” *International Journal of Political Economy*, November 5, 2015, <http://www.tandfonline.com/doi/abs/10.1080/08911916.2015.1035986?journalCode=mijp20>, p. 174-195.

⁴¹ S. Storm, “Rejoinder to Flassbeck and Lapavitsas,” Institute for New Economic Thinking, January 28, 2016, <https://www.ineteconomics.org/perspectives/blog/rejoinder-to-flassbeck-and-lapavitsas>.

⁴² S. Storm and C.W.M. Naastepad, “Crisis and Recovery in the German Economy: The Real Lessons,” Institute for New Economic Thinking, March, 2014, <https://www.ineteconomics.org/research/research-papers/crisis-and-recovery-in-the-german-economy-the-real-lessons>.

To put it bluntly, the euro's problems cannot be adequately addressed either by Spanish unions asking for less or by German unions asking for more.

Fourth, the competitiveness argument suffers from a *linkage* problem. The data suggests German wage increases would make a weak direct remedy for Southern European problems. Both German exports and imports are not very sensitive to changes in unit labor costs. Thus, even if German costs jump, switching among customers may remain low because price elasticities for German exports are quite low. Wage hikes would need to be enormous before eroding German export firms' cost position. After all, German exporters have made plenty of profits with the Euro at \$1.35 and more. That's a long way from the current \$1.10.

The official German stance — which, again, is highly popular with German voters and broadly shared between the two largest parties — has an ambivalent fit with these findings.⁴³ On the one hand, they seem to vindicate the German claim that the euro's problems are not linked to low German wage costs. On the other hand, the findings also cast doubt on Germany's preferred narrative by undermining the idea that the euro's problems were caused by competitiveness factors, including in Southern Europe, the improvement of which constitutes the main line of German advice to the region since 2010.

To put it bluntly, then, the euro's problems cannot be adequately addressed either by Spanish unions asking for less or by German unions asking for more. These findings are relevant for the U.S. case, as well. Here, too, current accounts worsened much more by import increases than export declines.

⁴³ W. Jacoby, "Europe's New German Problem: The Timing of Politics and the Politics of Timing," in M. Matthijs and M. Blyth, *The Future of the Euro* (Oxford: Oxford University Press, 2015).

Moreover, America's already highly flexible labor markets have not prevented sharp current account deficits. By extension, however, the Trump administration's complaints about Germany "exploiting" the EU and its weak currency are not likely to lead to the real source of Germany's large and sustained trade surplus.⁴⁴ Worse, the red herring of purportedly German-engineered euro weakness invites an easy response from German officials like Schäuble, who can correctly point out that Germany opposed the quantitative easing that brought the euro lower.⁴⁵ Thus, a distracting and unconvincing U.S. complaint leads to a mostly irrelevant German response.

⁴⁴ Recall that Bundesbank estimates cited earlier attributed only 0.25 percent of the total 8.5 percent current account surplus in 2015 to the weak euro, though this was certainly higher in 2016, as the euro lost more value.

⁴⁵ B. Eichengreen, "Is Germany unbalanced or unhinged?" Project Syndicate, May 11, 2017, <https://www.project-syndicate.org/commentary/german-external-surplus-requires-public-investment-by-barry-eichengreen-2017-05>.

6 CAPITAL FLOWS AS PARADIGM SHIFT

What could break this stalemate? One important scholarly conversation has not yet been subject to Germany's "normalize and apologize" routine. Instead, it has been largely ignored, in part because the ideas are counterintuitive and intrinsically hard to follow but also because its message is an unwelcome one in Germany. This alternative view holds that the euro area's problems are best seen through the light of capital flows and not, as in the competitiveness debate, through trade (current account) flows.⁴⁶ This perspective sees trade surpluses not as the result of cost control and great products alone but the necessary complement of capital outflows, whose causal weight can "dominate" the trade balance in the age of financial globalization. Trade surpluses are not a sign of a country "winning," as the annual celebratory *Exportweltmeister* stories in *Bild* often imply. They are, instead, often a sign of major mismatches in a country's savings and investment rates. This section unpacks these difficult ideas and applies them to the German surplus debate.

We begin not with great German products but with the spike in German national savings, which grew from roughly 21 percent to 28 percent of German GDP during the period in question (2003-2017). Why should it matter

to others how much Germany saves? Because national savings don't just sit in banks and often have large unanticipated knock-on effects. Since global savings and investment *must* equal one another by definition, savings *increases* in one place logically *must* be matched either with investment growth (there or somewhere else) or by savings *declines* somewhere else.⁴⁷ Broadly, Germany is one of a number of countries, including China, Japan, and South Korea that are now saving far more than they are either consuming or investing (a country's GDP is the sum of its consumption and investment, and, since all GDP is income for the nation's residents, another way of putting this is that GDP is the sum of consumption and savings — the two things people can do with their income.).

What happens to those "extra" savings (e.g., in excess of the nation's total investment)? According to macroeconomic theory and data, *they are going to any country with a trade deficit*. Indeed, another way to understand a country's trade surplus is that it is (and must be) exactly equal in size to its investment deficit.⁴⁸ The literature on capital flows foregrounds the importance of this relationship and spells out a number of its counterintuitive and often unwelcome results, including how difficult it is for countries to deal with unwanted capital inflows when their current investment needs are largely covered.

Thus, where German apologists claim Germany's trade surplus is simply the aggregate result of free consumer choices, this approach

Trade surpluses are not a sign of a country "winning," as the annual celebratory Exportweltmeister stories in Bild often imply. They are, instead, often a sign of major mismatches in a country's savings and investment rates.

⁴⁶ Pettis, *The Great Rebalancing*; K. Austin, "Secular Stagnation and Two Articles of Faith of the Conventional Wisdom," *World Economics*, 17(3), 2016, <http://www.world-economics-journal.com/Secular%20Stagnation%20and%20Two%20Articles%20of%20Faith%20of%20the%20Conventional%20Wisdom%20details?AID=648>, pp. 55-90; P. Temin and D. Vines, *The Leaderless Economy: Why the World Economic System Fell Apart and How to Fix It*, (Princeton, New Jersey: Princeton University Press, 2013); Baldwin et. al., "Rebooting the Eurozone: Step 1 – Agreeing a Crisis narrative;" E. Jones, "Shifting the Focus." A more technical version focused on gross capital flows rather than net flows in the current and capital accounts has been pioneered by H.S. Shin, "Global Savings Glut or Global Banking Glut?" *Vox EU*, December 20, 2011, <http://voxeu.org/article/global-savings-glut-or-global-banking-glut>.

⁴⁷ Pettis, *The Great Rebalancing*, pp. 29-32, 50-52; Austin, "Secular Stagnation."

⁴⁸ Technically, central bank reserves play a part in this balance, along with "errors and omissions."

In today's world awash in capital, there is little need for more savings (think of Ben Bernanke's "savings glut").

suggests it is mostly the result of Germany's capital outflows, which themselves are the result of policy choices, especially those that shift national income from consumers to firms (as profits or capital subsidies) or government (as budget surpluses). Global capital flows have their own logic and have now grown to dwarf trade flows. Scholars such as Michael Pettis have shown that countries that persistently save more than they invest, are often troublesome, either regionally or globally or both.⁴⁹

Yes, capital inflows can be positive.⁵⁰ If and when the rest of the world needs a country's excess savings, this can lead to productive investment and a win-win scenario. This positive scenario characterizes, for example, the U.S.–UK relationship in the 19th century, when America needed capital but tended not to save it, in part because of the parlous state of American banking. Britain had plentiful capital and so ran a big trade surplus with the United States, exporting both goods and, necessarily, its excess savings to the mutual satisfaction of both sides. In today's world awash in capital, there is little need for more savings (think of Ben Bernanke's "savings glut").⁵¹

⁴⁹ Pettis, *The Great Rebalancing*, pp. 128-135, 142-149.

⁵⁰ That said, a recent meta-analysis finds no evidence for the idea that transnational capital flows have enhanced growth. H. Ray, "Capital Account Management" in G. Akerlof, O. Blanchard, D. Romer and J. E. Stiglitz, (ed), *What Have We Learned? Macroeconomic Policy after the Crisis* (Cambridge, MA: MIT Press, 2014) pp. 307-13.

⁵¹ A different approach is the so-called "banking glut," which puts more emphasis on how the rapid rise of cross-national banking has actively "pushed" savings into new markets. H.S. Shin, "Global Savings Glut"; O'Connell, "European Crisis."

But with free capital flows a part of eurozone rules and the liberal international order, there are few mechanisms for stopping inflows. The inflows, if they cannot be used productively, reliably generate problems for receiving countries. How? Since savings must, again by definition, match investment, those inflows that aren't invested must generate lower savings in the receiving country. There are two main ways this happens: either through an (unsustainable) consumption boom or an (unfortunately quite sustainable) increase in unemployment.⁵² Consumption decreases savings by increasing debt; unemployment causes savings to shrink as people live off past earnings. Of course, German capital flows are not the only contributor to consumption booms and unemployment in Southern Europe or the United States. The problem is that the German debate almost never acknowledges how disruptive they can be.⁵³

What German policies most contributed to these outcomes? It is possible to root the same capital flow imbalances in several different mechanisms, including redistribution of income away from lower-saving households to higher-saving businesses during Germany's Hartz reforms,⁵⁴ Germany's remarkably

⁵² For details on the mechanisms causing unemployment, see Pettis, *The Great Rebalancing*, pp. 104-106, 110-116; also M. Pettis, "Syriza and the French Indemnity of 1871-73," Carnegie Endowment for International Peace, February 4, 2015, <http://carnegieendowment.org/chinafinancialmarkets/58983>.

⁵³ For a partial exception, see Bertelsmann Stiftung "Deutschlands Exportüberschuss: Fluch oder Segen?" October 2015, https://www.bertelsmann-stiftung.de/fileadmin/files/BSt/Publikationen/GrauePublikationen/NW_D_Exportueberschuss_2015.pdf. The report notes that Germany "exports its unemployment" (p. 3) but then laments that the debt-brakes and demographic developments must sharply limit the state response, pp. 4-6, 11-13.

⁵⁴ Pettis, "Syriza and the French Indemnity"; Johnston, Hancké, and Pant, "Comparative Institutional Advantage."

regressive social security taxes,⁵⁵ and (later) its increase in consumption taxes all pushed down household shares of national income (and thus pushed up national savings rates). Meanwhile, Germany's already lagging public and private investment mostly lagged further,⁵⁶ and the push factor of transnational banking,⁵⁷ combined with the pull factor of less-developed Southern states seeking Northern capital, sent these funds abroad.⁵⁸

Early on, the excess German savings flowed primarily inside the new eurozone, because its single (low) interest rate coupled with higher inflation in the South meant real interest rates in the South were especially low, giving borrowers there stronger incentives.⁵⁹ The resulting capital inflows initially funded many sensible projects, but the lending boom gathered strength as wealth effects drove up collateral prices. Borrowers showed little inclination to stop this boom, and given eurozone rules, states could not legally stop these capital inflows had they wished to. While any given Southern European citizen could say “no” to loans at very low real rates — and millions did say “no” — national policymakers could not stop them from

accessing this capital, freely offered by other eurozone banks. And once the credits were accepted, the savings thus displaced were then, by definition, turned to consumption, causing a trade deficit for the country importing capital. German exporters soon began to feast on the dynamic sparked by these capital outflows.⁶⁰

But despite these European peculiarities, the causal path was roughly the same macroeconomic context as other global flow problems that result in unneeded capital inflows in countries that are ideologically inclined to ease such inflows and to consider them unproblematic. As Pettis summarizes the case, a similar scenario:

“...is exactly what seems to have happened to the global economy. As savings were forced up structurally, whether because of rising income inequality or a declining household share of GDP, the system responded in ways that were sustainable (increases in productive investment) and in ways that were unsustainable (rising inventory in China, increases in speculative investment in the US, China, and Europe, and increases in credit-financed consumption in the US and southern Europe). At some point excessive debt eliminated all the unsustainable ways, and we were forced into accepting the remaining sustainable way, which is an increase in unemployment.”⁶¹

Early on, the excess German savings flowed primarily inside the new eurozone, because its single (low) interest rate coupled with higher inflation in the South meant real interest rates in the South were especially low, giving borrowers there stronger incentives.

⁵⁵ A. Hassel, “No Way to Escape Imbalances in the Eurozone? Three Sources for Germany’s Export Dependency,” forthcoming in *German Politics*, 2017.

⁵⁶ M. Fratzscher, *Die Deutschland-Illusion: Warum wir unsere Wirtschaft überschätzen und Europa brauchen* (Munich: Carl Hanser Verlag, 2014).

⁵⁷ C. Borio, H. James, and H.S. Shin, “The International Monetary and Financial System: A Capital Account Historical Perspective,” Bank for International Settlements: BIS Working Papers, August 2014, <http://www.bis.org/publ/work457.pdf>.

⁵⁸ Baldwin et. al., “Rebooting the Eurozone: Step 1 – Agreeing a Crisis narrative”; E. Jones, “Financial Markets Matter More.”

⁵⁹ Others went outside the eurozone to Central and Eastern Europe. W. Jacoby, “The EU Factor in Fat Times and Lean: Did the EU Amplify the Boom and Soften the Bust?” *Journal of Common Market Studies*, 52 (January 2014), 52–70, <http://onlinelibrary.wiley.com/doi/10.1111/jcms.12076/abstract>.

⁶⁰ E. Jones, “Competitiveness.”

⁶¹ M. Pettis, “Economic Consequences of Income Inequality,” Carnegie Endowment for International Peace, March 23, 2014 <http://carnegieendowment.org/chinafinancialmarkets/55084>.

The evidence is compelling for a capital flows-focused approach, at least insofar as it shows an important shift in the German economy commensurate with the onset of the trade surplus in 2004.

This approach does three things unusual in the German debate. First, it links a borrowing binge to a prior German savings binge that generated capital well beyond Germany's investment needs. Second, it denies that foreign borrowers had legal alternatives to accepting Germany's imported capital. And third, it links German export sales to consumer demand that Germany must import from abroad precisely because it has taken policy steps to deny itself the capacity to consume its own product (or an equivalent amount of foreign products). Here, capital flows are made the dog and trade flows the tail that gets wagged. Engineering is demoted as the key to German success. And low German wages become problematic not primarily because they "undercut" other states but because they are part of a whole range of policies that, together, depress German consumption and imports and, instead, import demand from other states. And Germany's much-lauded foreign direct investment (FDI) in the American automobile sector becomes only part of a larger story in which much of the capital finds much less productive — often damaging — outlets. This approach is counterintuitive and much harder to summarize in pithy microeconomic analogies about housewives and firms.

What do German officials say about this cluster of ideas? For the most part, they say nothing at all. While officials, when pushed, will depart from the competitiveness language and acknowledge the high savings as part of a demographic trend, I cannot find any examples of German politicians taking seriously the core ideas of a capital-based approach to the problem. Thus, while they may characterize high German savings as a positive contrast to low American savings, they seem unaware of the idea that the two trends are causally linked and the result

harmful to the U.S. economy. Several well-connected political figures have acknowledged in private conversations that these mechanisms are not part of their conversations about the trade surplus and that they have never heard them. I take them at their word. Moreover, these issues play no prominent role in any German economic reporting of which I am aware.⁶² Instead, most journalists also focus on damning the concern with domestic demand as "simple Keynesianism" when in fact this approach draws much of its inspiration from firm-based balance sheet approaches.

The evidence is compelling for a capital flows-focused approach, at least insofar as it shows an important shift in the German economy commensurate with the onset of the trade surplus in 2004.⁶³ Consider the following trends, bearing in mind the central causal claims that a) policies can shift income from households to firms (or governments), thus increasing savings rates, either by growing profits or paying down debt; and b) that other policies can directly and indirectly affect investment rates: Between 2003 and 2016, German final consumption fell from 76.6 percent of GDP to 73.3 percent, private consumption fell from 57.7 percent to 53.6 percent, and household consumption showed an even more impressive drop from 56.1 percent to 51.8 percent. Over the same period, total domestic demand fell from 96.3 percent of GDP to 92.5 percent. Individual consumption fell from 69.3 percent to 66.4 percent. As consumption falls, we expect savings increases,

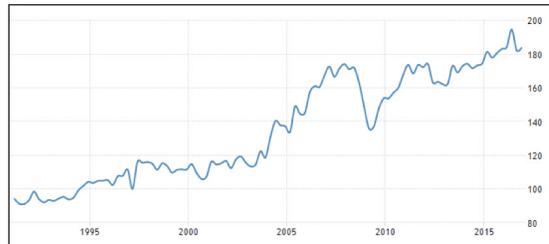
⁶² More usually, the concern is that Germany is getting IOUs for good German products. See e.g., K. Rudzio, "Angriff auf Berlin," *Die Zeit*, February 18, 2017, <http://www.zeit.de/2017/07/exportueberschuss-waehrungsmanipulation-weltwirtschaft-usa/komplettansicht>; Schnabl, "Why Trump is Right."

⁶³ All data in this paragraph are taken from Haver Analytics.

which indeed jumped sharply. Net domestic savings more than doubled, from 4.1 percent of GDP to 10 percent over the period, and gross savings jumped from 21.1 percent to 27.7 percent.

Also consistent with this approach, German gross investment, which had already fallen off sharply from the mid-1990s unification period, fell further from 19.7 percent of GDP in 2003 to 19.1 percent in 2016. Government investment remained roughly stable across the period at 2.1 percent, though, as noted, this is well below the OECD average. With investment stable but savings way up, Germany's net lending abroad surged from 1.7 percent of GDP to 8.6 percent. As indicated in Figure 3, the increase in German household savings, while impressive on its own, is complemented by much sharper increases in German corporate profitability.⁶⁴ Again, the sharp increase around 2004 is consistent with the timing of the onset of Germany's current account boom and entirely consistent with the broad causal mechanisms of the capital account approach to trade. The difference between national savings of 21 percent and 28 percent in a \$3.5 trillion economy is \$245 billion, which is (as it must be) very close to Germany's 2015 current account surplus of €257 billion.

Figure 3: German Corporate Profits (Billion Euros per Year)



Source: Trading Economics, <http://www.tradingeconomics.com/germany/corporate-profits>.

While many German economists clearly do understand these deeper linkages,⁶⁵ the Bundesbank's own official reports on the German balance of payments go to extraordinary lengths to ignore the connections noted above between capital and current accounts. For example, the 20-page 2015 report never mentions the basic identity of current and capital accounts for lay readers, consistently uses both prose and charts to obscure any connection between the two, and cites none of the academic debates that show capital outflows can be disruptive.⁶⁶ The report never mentions the word "savings," and doesn't report on German portfolio outflows — by far, the largest component of the capital account — until an extended section dominated by the purported ills of the ECB's quantitative easing program. In short, the Bundesbank report ignores the issues raised here and is structured in a way that helps readers stay focused on the microeconomic paradigm of competitiveness.

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⁶⁴ Profits not distributed to shareholders are a form of savings.

⁶⁵ With markedly different conclusions, capital account issues arise in the Bofinger, Bertelsmann, Sinn and Schnabl articles cited earlier.

⁶⁶ Bundesbank, "German balance of payment in 2015."

On the eve of the global financial crisis, 20 of 28 EU states had a current account deficit, and 7 of these national deficits were more than a whopping 12 percent of GDP. Today, these figures have dramatically reversed, with 20 of the 28 current member states in surplus.

The capital flows account gives both reasons and evidence to think that Germany's current account surplus is being driven, at least in part, by the surge in German savings relative to the stagnation of German investment. And it undercuts the implicit German official position that trade flows are primarily the result of the competitive strength of German firms combined with free choices of global consumers. Instead, Southern Europe's problems arose not primarily from too little "competitiveness" but from too much foreign capital. Contrary to the competitiveness mantra, it is thus pointless to look for major solutions in structural reforms aimed to "restore competitiveness" of particular sectors. And contrary to the rectitude mantra, the real issue is the lacking aggregate demand in Europe and particularly the South.⁶⁷

How does all this intersect with the techniques of "normalize and apologize"? First, by helping push internal devaluation in the eurozone (along with other Northern allies), Germany has helped make current account surpluses the "new normal" in Europe. On the eve of the global financial crisis, 20 of 28 EU states had a current account *deficit*, and 7 of these national deficits were more than a whopping 12 percent of GDP.⁶⁸ Today, these figures have dramatically reversed, with 20 of the 28 current member states in *surplus*. Of the 8 states running a deficit in 2016, all were small deficits (e.g., less than 1 percent), except for Romania (2.3 percent), the UK (4.4 percent), and Cyprus (5.3 percent).

⁶⁷ M. Blyth, "Policies to Overcome Stagnation: The Crisis, and the Possible Futures, of all Things Euro," *European Journal of Economics and Economic Policies*, 13(2), 2016, <https://www.elgaronline.com/view/journals/ejeep/13-2/ejeep.2016.02.06.xml>, pp. 215-228.

⁶⁸ This paragraph uses Eurostat data for 2007 and 2016. <http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tipsbp20&plugin=1>.

This pattern is bound to lead to conflict with the outside world almost independent of whom the U.S. president might be.

As that broader conflict takes shape, Germany's apologists are running out of credible answers. The larger the size of the problem, the harder it is to sell the apologists' message that "Germany is just different." More important, the larger number of European countries whose trade profiles start to look more like Germany's, the less plausible is the claim of difference. Eventually, the successful normalizing undercuts the apologizing. All this goes back farther than the Hartz reforms. Take wage cutting: in the early 1970s, German service sector wages were 95 percent of those in manufacturing. Already by the mid-2000s, they were down to 65 percent.⁶⁹ Combined with a large tax wedge on labor and increased consumption (value-added tax) taxes in 2007, the purchasing power of much of German society is so weak that it's no wonder they rely heavily on external demand. Stepping back a bit, behind the exotic gloss of German institutions and ordoliberal pieties, it's not hard to recognize the contours of the familiar export-led developmental model of East Asia, with its repressed savers, low domestic consumption shares, and a range of subsidies for exporting industries.⁷⁰

Moreover, when others point out that Germany's policies (intentionally or unintentionally) now redistribute income from those who spend more to those who save more and that Germany's

⁶⁹ Hassel, "No Way to Escape Imbalances?"

⁷⁰ Pettis, *The Great Rebalancing*, pp. 78-84. For the argument that East Asia borrowed its export model from Germany in the first place, see W. Streeck and K. Yamamura, *The Origins of Non-Liberal Capitalism* (Cambridge, UK: Cambridge University Press, 2002).

recent savings-investment gap is creating much larger unwanted external investment flows that aren't being used productively abroad and so are leading to higher unemployment and higher fiscal deficits, Germany's response that it doesn't believe in Keynesianism isn't a good enough answer. It is not necessarily Keynesian to worry about the scarcity of demand, indeed it is economically illiterate not to.⁷¹

⁷¹ For the way neo-liberal econometric models go beyond "comic book versions of laissez-faire economics," and incorporate demand-side factors, see C. Ban, *Ruling Ideas: How Global Neoliberalism Goes Local* (Oxford: Oxford University Press, 2016), pp. 2-4.

7 WHICH SURPLUS, WHICH GERMANY?

“Surplus Germany” can also refer to too much Germany — too much advice, too much self-confident prescription, too much protestation of innocence or impotence, and too much evasion.

This policy paper’s title “Surplus Germany” has a double meaning. It refers to Germany’s massive and sustained goods trade surplus and to the contentious arguments behind its causes and likely persistence.⁷² Germany and the United States are currently stuck in an unhelpful debate in which their publics are being plied with shallow and superficial explanations of the international political economy. There is a more interesting debate among political economists. It addresses capital surpluses, and its answers are highly suggestive and worthy of sustained engagement by German officials. In both “surplus debates,” it seems increasingly unlikely that Germany’s “stand pat” answer is going to work in the long run. As more European countries are added to a substantial list of Asian countries purposefully shifting resources away from domestic households (who consume much of their income) to firms (who often sit on mountains of cash), the number of countries chasing scarce demand abroad rises. Rising global inequality further exacerbates the problem.

“Surplus Germany” can also, however, refer to too much Germany — too much advice, too much self-confident prescription, too much protestation of innocence or impotence, and

too much evasion.⁷³ For a long time, Germany’s official response to complaints about its current account surplus was a form of “we shouldn’t.” *We shouldn’t take any policy steps to address trade because outcomes reflect product prices and quality and free consumer choices and nothing else.* Over time, German officials have instead increasingly stressed, “we can’t.” *We can’t help that our population is aging. We can’t help that our business class prefers to invest abroad and not at home. We can’t help that wage dualism is growing fast. We can’t invest on behalf of our municipalities.*

Yet even in a capitalist economy, there remain ample levers for the German state to do much more — a point it surely recognizes with its periodic efforts to publicize increases in real wages, the introduction of the minimum wage, deliberations about minimum pensions, or plans for future increases in education and public investment (again, from extremely low levels). But this is almost always about “normalizing” what’s already been done. The message seems to be: *We can’t affect wages, but the real wage increase this year was large, so stop complaining.*⁷⁴ When asked to make real commitments to follow the EU’s rules and its own laws — both of which arguably commit the country to striving for balanced trade — German officials then move well past

⁷² The IMF predicts that on its current trajectory, the German surplus will decline by only about 1 percent of GDP by 2022 (e.g., to about 7.3 percent). See International Monetary Fund, “Germany: Staff concluding statement of the 2017 Article IV mission,” May 15, 2017, <http://www.imf.org/en/News/Articles/2017/05/15/mcs05152017-Germany-Staff-Concluding-Statement-of-the-2017-Article-IV-Mission>.

⁷³ W. R. Mead, “Stubborn Germany Rejects Trade Criticism,” *The American Interest*, March 28, 2017, <https://www.the-american-interest.com/2017/03/28/stubborn-germany-rejects-trade-criticism/>; P. Hockenjos, “Germany Has an Arrogance Problem,” *Foreign Policy*, April 27, 2017, <http://foreignpolicy.com/2017/04/27/germany-is-getting-too-arrogant-merkel/>; M. Matthijs (2016), “Powerful Rules Governing the Euro: The Perverse Logic of German Ideas,” *Journal of European Public Policy* 23(3): 375-91, <http://www.tandfonline.com/doi/abs/10.1080/13501763.2015.1115535?journalCode=rjpp20>.

⁷⁴ Schäuble, “International Monetary and Financial Committee Statement.”

“we shouldn’t” and “we can’t” and simply say “we won’t.” Meanwhile, those economists who see the link to capital flows tend to portray Germany as the victim because its foreign investments often lose money.⁷⁵

What policy steps might rescue all sides from this miserable standoff? While many useful lists of prescriptions are already available,⁷⁶ the key priorities of increasing investment and boosting the incomes (and, hence consumption) of lower income classes bear brief repetition: in addition to the helpful steps noted in the last paragraph, the government urgently needs to 1) reduce taxes on labor and consumption (such as value-added tax), 2) take a much more aggressive stance that moves public investment from the low end of the OECD to the higher end, and 3) find ways either to reduce soaring savings rates or improve the investment climate for firms. Special investment funds — such as that already envisioned for transportation — might also be established for schools and hospitals. Minimum pensions could be established. Investments in refugee training, housing, and medical care could be enhanced substantially. Germany could more aggressively take the lead in European-wide initiatives in defense, refugee integration, border protection, and research and development.

The problem is that much of this policy agenda has been repeatedly rejected in Germany as unnecessary or unwise. Thus, what’s really required is a shift in understanding of the

⁷⁵ As indeed they must if the receiving states are poorly-situated to invest productively or accommodate further debt. Rather than increasing other countries’ debt or consumption bubbles, more German capital should stay at home.

⁷⁶ See International Monetary Fund, “Germany: Staff concluding statement of the 2017 Article IV mission,” for one comprehensive list.

deeper roots of the current mess, which is what this policy paper has tried to provide. What’s required, in short, is an end to the pernicious fiction that German policy choices had and have little to do with the imbalances that already exist. German officials must see that the more European states follow variants of the German recipe, the harder it is politically to “normalize” the resulting trade surpluses and extra-EU imbalances, including with the United States.

Moreover, it is harder to apologize when your purported national peculiarities — such as aging societies, pay-as-you-go welfare systems, and lots of inequality — turn out to be the same things many other states are struggling with. When Germany’s solutions to these problems have big negative effects on others — and they do — the “normalize and apologize” tactics reach the end of their utility. And this is what has now happened. As bizarre as the actual *form* of the Trump administration’s complaints might be, they *are* driven by a deep truth: Germany’s surplus is disruptive, it has roots in domestic (and euro-area) policies, and if the policies changed, so would the size of the surplus. And quickly.

To be sure, one can be sympathetic to the predicament of German elites. Their job is hard and their challenges very real. It’s not just that they live in an echo chamber in which there are few alternative voices and no real debate on economic policy and thus little electoral incentive to understand and address Germany’s real position. It’s also that Germany *already* redistributes a lot of income, among the highest levels in the OECD.⁷⁷ Its population *is* getting old. Its labor force *is* shrinking. Its educational

⁷⁷ Fratzscher, *Verteilungskampf*.

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The time has passed for German elites to trash cartoonish versions of objections to their policy mix to German voters. This just makes the entire polity more susceptible to bad economics, and in age of rising populism, this cannot be a good thing.

inequality is high. Its innovation culture has not broken into new sectors. Its path to higher investment is blocked by unclear energy policies on one end and, on the other, by a mismatch between investment needs and investment competence among the levels of government. German officials are absolutely right to insist that their country has important weaknesses that are often missed by outsiders consumed with their own problems.⁷⁸ Yet none of these very real dilemmas justifies their self-serving narrative on trade and denial of the role their capital outflows play in *causing* problems in countries legally obliged not to restrict them.⁷⁹

Since Germany is in election mode until fall 2017, both major parties will have incentives to push back rather defiantly on any U.S. (or other outside) pressure. In this sense, it seems felicitous that President Trump has decided to try his hand on fixing NAFTA first. As we have seen, the German government anyway addresses all criticisms — from inside and outside the eurozone — with roughly the same answer: *our success proves we are right*. This is what really has to change in Germany. German elites (to start) must begin to debate amongst themselves the terrifying proposition that some of their critics are right: that Germany's success, far from being a model for others, is both derivative of other countries' misfortune in some important ways and, if widely emulated, will lead to the

breakdown of the international system upon which Germany — more than almost any other country — is utterly dependent.

This does not make Germany an economic predator or its leaders fools. Until recent years, few economists have understood these linkages clearly, and there remains a great deal to learn and much more evidence to gather. But the time has passed for German elites to trash cartoonish versions of objections to their policy mix to German voters. This just makes the entire polity more susceptible to bad economics, and in age of rising populism, this cannot be a good thing in Germany, any more than it is in the United States. German officials have the good fortune of having a reform-minded partner in the new French President Emmanuel Macron. Presumably, Macron will spend his summer making a push for domestic reforms. When Germany's electoral dust settles in September, the country would be well-served to consider meeting him more than halfway. The time for Europe's reforms stopping at Germany's borders has to end.

⁷⁸ A good summary is H. James, "Can Germany Make Globalization Work?" Transatlantic Academy, March 2017, <http://brussels.gmfus.org/publications/can-germany-make-globalization-work>.

⁷⁹ For the argument that the United States could and should restrict capital inflows, see Austin, "Secular Stagnation," pp. 75-8; for the causal mechanisms on unemployment, see Pettis, *The Great Rebalancing*, pp. 104-106, 110-116.

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