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Germany's Two-edged Business Model

Current Account Surpluses Fund Investment and Consumption – Abroad

Heribert Dieter

Germany is facing a storm of criticism over trade. Numerous commentators, as well as the European Commission and the US Treasury, have condemned the German current account surpluses in recent weeks, objecting to the large export surplus and demanding its reduction. Germany would indeed have every reason to rethink its business model. Since 2000 German companies and investors have invested abroad on a grand scale – and lost a great deal of money in the process. Exporting capital has often been an expensive pursuit. It might therefore make sense to invest less abroad and more at home. But certain economies, especially in eastern Europe, would suffer under such a strategy shift, as cutting German current account surpluses would inevitably reduce the volume of foreign investment.

Although complaints about German current account surpluses are nothing new, the criticism has rarely been as massive as in November 2013. Paul Krugman, economist and columnist for the *New York Times*, came down particularly hard: "Those depressing Germans", he wrote, pulling no punches. While the crisis-hit countries of southern Europe were reducing their current account deficits, he continued, Germany continued to produce enormous surpluses. This was "a very bad thing for Europe", because it made it even more difficult to overcome the crisis in the south. The *Financial Times* commented that the Germans had so much money that they could certainly stay for a day longer on Rhodes or buy another designer handbag from Milan. In the same newspaper Martin Wolf called Germany "a weight on the world". EU Economic and Monetary Affairs Commissioner Olli Rehn has opened an economic imbalances procedure and called on Germany to boost domestic demand and investment. Domestic demand in particular is repeatedly recommended as a miracle cure. A noticeable increase in wages paid in Germany would, it is suggested, not only boost import demand, but also blunt the competitiveness of German businesses and thus smooth the way for an upturn elsewhere in Europe. However, higher wages do not automatically increase imports. If the wage growth does not flow into demand for foreign goods, but merely increases domestic savings, higher wages would in fact cause a further increase in the current account surplus.

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SWP Comments 37
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The Balance of Payments and Its Components

However, there is a certain basis to some of the criticisms. A country's current account comprises its trade in goods and services with other countries. Taken together, all the current accounts in the world add up to zero. If Germany, Switzerland and the Netherlands run surpluses, there must be other countries that permit deficits. This is often the point of criticism: only because other countries import more than they export can Germany afford to accumulate surpluses. Germany lacks sufficient domestic demand, leading its businesses to sell their products abroad.

One widespread error is to consider only the left-hand side, the current account. The right-hand side, the capital account, is equally important. An economy that generates a current account surplus must simultaneously be exporting capital. Germany sells BMW and Mercedes cars and at the same time exports the loans needed to purchase them. The German economy grants the rest of the world a gigantic supplier credit. This is itself at least a questionable model. Germany accumulates claims against other countries whose fulfilment is not ensured.

The flip side of the German current account surpluses is thus an enormous export of capital, because little is invested in Germany. Here there have been enormous shifts in recent years. During the 1990s investment in Germany was still above the mean of the other G7 countries. Strong investment in Germany was – inevitably given the mechanics of accounting – associated with current account deficits. But since 2000 investment in Germany has been weak. In 1992 gross fixed capital formation was still 23.5 percent of GDP (G7 without Germany: 21.3 percent). The figure fell to 17.2 percent of GDP (G7 without Germany: 18.5 percent) by 2009 and has hardly recovered since then. So the large surpluses of recent years would have been impossible without weak domestic investment and strong domestic savings.

The widely accepted interpretation of the balance of payments focuses on the current account and regards the capital account as the "passive result". This one-sided view was already criticised in the 1950s by economists and economic policymakers who emphasised that the financing side was just as important as the current account. Today, in an era of capital movements divorced from current account transactions, that argument has gained even greater weight. Companies and investors transfer capital abroad without any export of goods being required.

If one considers both sides of the balance of payments, Germany therefore has a whole series of possibilities to reduce its current account surpluses: reducing exports and increasing imports or reducing domestic savings and increasing domestic investment would both serve the purpose. But it would equally be possible to reduce German investment abroad, and here the effects on other countries would by no means be positive. Another possibility would be to stimulate foreign investment in Germany.

The phase of large current account surpluses beginning in 2005 has to date been associated with strong foreign investment. Between 2005 and 2012 German businesses invested €557.0 billion abroad, while foreign businesses invested only €233.6 billion in Germany. The difference – €324.4 billion – appears as capital export in the balance of payments. The reticence of foreign businesses to invest in Germany is, however, not the result of German entrepreneurial decisions. During the 1990s foreign businesses invested much more strongly in Germany – which caused current account deficits at that time. One example was Vodafone's takeover of Mannesmann in 2000, which led to an inflow of capital to Germany. In recent years on the other hand, capital has flowed out of Germany, because neither German nor foreign businesses wanted to expand their investments in Germany. Instead German companies invested abroad.

So it is precisely the internationalisation of German business that has largely produced the rise in capital exports. For example, German car manufacturers have been investing strongly abroad for years. Today Audi manufactures almost all its engines in Györ, Hungary, while rival Daimler's new plant at Kecskemét, also in Hungary, opened in March 2012 creating jobs and stimulating further investment by suppliers.

These investments in eastern Europe are not isolated cases. In 2010 German manufacturers for the first time produced more cars abroad than in Germany. That trend has amplified since. In 2012 BMW, Mercedes and VW produced 8.2 million cars abroad against 5.4 million at home. So to Hungarian observers there is nothing threatening about German surpluses, which they see as a mainstay of their economic upturn. In one Hungarian editorial published on 15 November 2013 we read that "German car manufacturers and their Hungarian plants are like a team of buffaloes pulling the cart of the Hungarian economy". Indeed, it continues, they should perhaps send a "thank-you telegram to Chancellor Angela Merkel".

German companies have also invested massively in the United States, whose Treasury so loudly criticises German surpluses. BMW, Daimler and Volkswagen have all built factories in the United States, as has BASF, and as such strengthened the US economy. The accusation that Germany consumes too little can thus be turned around: Germany invests too much – abroad. Conversely, it is also true that the United States has suffered weak domestic savings and has for years had its investment and consumption funded by other countries. But a prosperous developed economy like the United States should really – like Germany – be exporting capital to emerging economies and developing countries rather than importing capital from them. Implementation of the US business model has been helped by the exemption from taxation on interest for foreign investors introduced in 1984. From 2000 to 2008 more than $5,300 billion of foreign capital, including $1,600 billion in direct investment, flowed into the United States, contributing amongst other things to inflating the bubble in the US real estate market.

Germany's Foreign Investments

The German model is fundamentally appropriate for a developed economy. Future pensioners save for their old age, and their savings are invested in countries that promise attractive growth rates. However, the implementation of this approach has not worked well in Germany. German investments abroad have often failed, and this is clearly reflected in the balance of payments. From 2000 to 2012 Germany earned cumulative current account surpluses of €1,275 billion, which is a considerable order of magnitude. Those surpluses should today – if the investment decisions were sound – be matched by claims against other countries of at least the same volume. But unfortunately this is not the case. German investors were frequently foolish, blindly following apparent trends, for example buying up American mortgage-backed securities and Greek government bonds. Misinvestments like the failed globalisation strategy of steel giant Thyssen-Krupp – where €9 billion worth of writedowns had to be made on steelworks in the United States and Brazil – also contributed to German foreign assets shrinking rather than growing.

Claims against other countries today amount to only €1,013 billion, so the losses add up to €269 billion. That corresponds to a writedown of 21 percent, or about 10 percent of Germany's annual economic output. Put another way, part of the goods exported from Germany were supplied free of charge. Of course their manufacture provided jobs for workers and profits for their exporters. While sensible at the business level, these transactions were nonetheless questionable successes in macro-economic terms.

Germany's current business model appears even more problematic if we consider not the cumulative surpluses but the trend in foreign assets. The European Commission has done this, calculating a yawning gap of €650 billion between the maximum one-time level of German claims against other countries and the current level. So the surpluses generated have flowed into less durable assets. The book losses of €650 billion identified by the Commission correspond to more than double Berlin's federal budget (or about one hundred times its annual spending on development cooperation or almost fifty times the annual spending of the Federal Ministry for Education and Research).

Foreigners watched with astonishment as the Germans squandered their wealth. Even before the US real estate bubble burst, traders on Wall Street were asking who was actually buying the overpriced securities. "Düsseldorf", was the answer: "Stupid Germans. They take the rating agencies seriously. They believe in the rules." The British mock the Germans as "penny-wise, but pound-foolish". While the search for the causes of German foreign investment failures has perhaps only just begun, German bank managers without doubt contributed heavily to the disconcerting contraction of German foreign assets. The state banks in particular burned unbelievable sums abroad.

So Germany has every reason to contemplate its business model. Continuing with a model built on export of goods appears rather unadvisable. Fetishising the "export world championships" is not sensible. Generating surpluses has proven ambivalent for the German economy. Either the surpluses should be invested more cleverly – or Germany should severely reduce its current account surpluses. The ideal way would be to strongly boost domestic investment activity. If one wished to return to the level of the early 1990s, that would mean raising annual investment by about €150 billion. Even raising the level to that of the other G7 countries would involve increasing annual domestic investment by about €30 billion.

The one-sided criticism Germany is currently experiencing is in no way plausible. To a great extent German capital exports have financed foreign direct investment and created jobs in eastern Europe, China and the United States. It is partly because of these direct investments that the eastern European economies are flourishing. And the Southern US states of Alabama, South Carolina and Tennessee benefit significantly from German private-sector investments. But apart from direct investments, Germany's capital exports have been so unsuccessful that the country has ample reason to reconsider its two-edged business model.

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