

Germany Prioritizes the Long-term Goal of Sustainability over the Short-term Goal of Revitalizing the World Economy

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ABSTRACT

While Germany continues to defend an open trading system it is not prepared to play a proactive role in pushing for liberalization of global trade. Preventing further disintegration in Europe has a higher priority for the German government than further integration in the world economy. Such priority does not only match with widespread skepticism in the German electorate on the gains from globalization. It also complies with an implicit understanding in the government that further globalization should be subject to stricter public surveillance. On financial stability, German authorities emphasize the need to minimize the role of taxpayers in future bail-outs and giving regulators the power to force troubled banks to restructure or liquidate. Germany is also keen for the imposition of a financial transactions tax at the global level. On macroeconomic policy, the increased reliance on domestic demand to spur growth in Germany will contribute towards global rebalancing. Given its fiscal space, boosting Germany's public investment could be part of a collective effort to address global demand weakness while addressing long-term growth challenges through structural reforms.

G7 | Germany | Economy | Finance | Foreign trade



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Introduction

In May 2017 Italy will host the Group of Seven (G7) summit while in July 2017 Germany will host the Group of Twenty (G20) summit. Both summits will take place against a background of persisting economic challenges and political uncertainties. The WTO notes that 2016 marks “the slowest pace of trade and output growth since the [global] financial crisis.”¹ Unemployment or underemployment, particularly among young persons, is still high in many parts of Europe and neighbouring developing countries. Risks to financial stability have risen as a result of record-high private and public debt, growing risks of asset bubbles and slow output growth. The monetary policy of leading central banks is still far more expansionary than in the past, relying mainly on unconventional measures, while fiscal policy has been on a consolidation or neutral path. The shaping of US domestic and foreign policy following the recent US presidential inauguration is contributing to ongoing economic and political uncertainties.

Against this background, this policy paper attempts to provide the German perspective on (i) the importance of an open rule-based, multilateral trading system, (ii) the stability of global financial markets and regulation and (iii) international coordination of macroeconomic policy.

¹ WTO, *Trade in 2016 to Grow at Slowest Pace Since the Financial Crisis*, 27 September 2016, https://www.wto.org/english/news_e/pres16_e/pr779_e.htm.

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1. The importance of an open rule-based multilateral trading system from a German perspective

For decades, the EU and the US have acted as a driving force in multilateral trade liberalization. The Blair House Agreement of 1992 between the two parties paved the way to the last multilateral round which was successfully concluded, the Uruguay Round. It also opened the door to an agreement on the World Trade Organization integrating the old agreement on trade in goods (GATT) into a broader system with multilateral agreements on trade in services (GATS) and intellectual property rights (TRIPS) plus a number of plurilateral agreements. In all these agreements, Germany acted as an active supporter. Since 2001, the successor agreement to the Uruguay Round, the Doha Round – labelled and promoted strongly by Germany as a “Development Round” – has been in limbo and is now very likely a “dead horse”. As an early alternative, the US and the EU went their own ways in concluding bilateral agreements with third countries. The US has labelled its switch from multilateralism to bilateralism as “competitive regionalism”, a policy designed to achieve a level playing field with the EU as the traditional forerunner of such agreements. Parallel to the ongoing bilateralism of the two parties and of China in East Asia, since 2013 the EU and the US have been negotiating TTIP, a new type of agreement which concentrates on cooperation and convergence in regulations for trade and investment. Unlike old agreements focusing on liberalizing border measures, these regulations aim at “behind the border” measures, i.e. national regulations which discriminate against foreign suppliers in favour of domestic suppliers, and thus violate so-called national treatment rules. The outcome of TTIP is not settled but strong civil protests against a feared “race to the bottom” in environmental and social standards, plus the fear that bodies and private dispute settlement schemes embedded in TTIP curtail democratic rights of parliaments, stand firmly against a straightforward conclusion. These protests have not stopped the much less controversial CETA agreement between the EU and Canada.

The message from such stock taking thus far is sobering. Neither multilateral nor new types of bilateral agreements can be concluded. Trade-restricting measures have grown in number more than twice as fast as trade-liberalizing measures. This is not to deny that there has been some success in multilateral trade facilitation (i.e. acceleration in customs clearance), especially in less advanced countries, and progress in some plurilateral sector-specific agreements. However, for the time being, the momentum of stimulating trade through global agreements is stifled by extreme concern in civil society that globalization has gone too far.

It seems paradoxical that the German electorate is in the eye of the storm against transatlantic trade liberalization since it is this electorate which to a large extent is employed in export-oriented SMEs. These SMEs are estimated to be the major beneficiaries of dismantling technical barriers to trade and other obstacles. To them, such barriers are particularly costly. Yet, both potential consumer gains and prospects of becoming more competitive from the removal of trade obstacles have been overshadowed by two concerns. First, it is feared that any mutual

Germany Prioritizes the Long-term Goal of Sustainability over the Short-term Goal of Revitalizing the World Economy

recognition of environmental, phytosanitary and sanitary standards or an ex ante harmonization of such standards would lead to a race to the bottom, thus undermining already high German standards. Second, private arbitration panels to settle investment disputes behind closed doors are perceived as a violation of democratic principles.

The electorate is widely split in its stance on trade liberalization and German policymakers have contributed to such ambivalence by paying only lip service to the conclusion of trade agreements. For a long time, Germany has played a more passive than active pro-trade role in the EU. In the German Ministry of Economic Affairs, the focus on designing liberal trade policies beyond the traditional mercantilist preference of export promotion has been much weaker than the focus on other domestic economic issues, and the price of the Ministry for its support of CETA (after the Canadian side conceded many open issues to the EU) has been an implicit death-sentence for the TTIP.

In the chancellery there is no representative in charge of furthering global trade and investment relations. In the trade directorate of the EU Commission, Germany has also been largely voiceless. Given the conflicting positions in the grand coalition on the merits of greater freedom in international trade and investment, it is unlikely that the German G20 presidency in 2017 ahead of federal elections will provide much impetus for bringing pending or ongoing negotiations to a successful end. Instead, conflicting positions within the grand coalition on issues like a firmer stance against China's recent investment outflows to Germany, assumed discrimination of German investment in China, and controls to tackle a feared "technology sell out" to China, are likely to prevent Germany from strongly promoting trade and investment liberalization in international fora. Moreover, the massive uncontrolled influx of refugees in 2015 was seen by many Germans as a threat to their own well-being and thus provoked resistance against further opening of markets.

2. Global financial markets' stability and regulation from a German perspective

Although the global financial crisis originated in the US mortgage market, the consequences for European banks have been disastrous. Public German Landesbanken as well as private banks like Commerzbank had to be rescued by taxpayers' money and the stress in the financial markets had to be alleviated by an immense supply of liquidity by governments and central banks. In the aftermath of the crisis, German politicians agreed that taxpayers' money must not be used to rescue banks in future crises. Thus, after the required actions to tackle the crisis had been taken, the search for appropriate reforms to increase the financial sector's stability began.

Germany Prioritizes the Long-term Goal of Sustainability over the Short-term Goal of Revitalizing the World Economy

As modern financial markets are globally integrated, supranational reforms were necessary. Firstly, the G20 members agreed on Basel III as a comprehensive set of reform measures which began to be implemented in 2013 and are continuing in phases until full implementation is complete in 2019. The main aim of Basel III is to improve the banking sector's resilience against shocks. Banks' capital requirements have been substantially increased to improve their loss-absorbing capacity. The minimum common equity ratio, for example, has been doubled. Further, the first common international liquidity requirements have been introduced to reduce banks' dependence on short-term external financing. Although these regulations have improved the stability of financial markets, it should be mentioned that equity ratios are calculated based on risk-weighted assets which are computed by banks' risk management and there is no guarantee that they represent the actual risk of a bank's operations.

German regulators addressed the too-big-to-fail problem in 2011 with a national law for restructuring troubled banks. Regulators can force troubled banks to restructure or liquidate. All potential expenses should be paid by the banking sector. Therefore, a restructuring fund was established which claims a bank levy. The levy a bank needs to pay increases with its size and the level of risk at which it operates. In 2015 the "European Bank Recovery and Resolution Directive" (BRRD) was implemented to produce a common regulatory framework across the Euro area. A "Single Resolution Fund" (SRF) was created which by the end of 2023 will contain 55 billion euros to enable it to guarantee or buy the assets of troubled banks. All institutions falling under the legislation need to contribute according to their systemic relevance and risk profile. If a bank needs to be rescued because its shareholders and creditors cannot accommodate losses or additional capital requirements, the SRF intervenes, not the taxpayer. The second pillar of the BRRD, the "Single Supervisory Mechanism" (SSM), established common supervisory standards and put systemically relevant banks in the Euro area under direct control of the ECB. The regulatory measures of the US Dodd-Frank Act of 2010 are comparable to the BRRD. A first real test was the troubled Italian Monte dei Paschi di Siena bank. Because Italian retail investors had heavily invested in the bank, the Italian government invoked exceptions for emergency cases in the BRRD legislation to recapitalize the bank with taxpayers' money so as not to also bail out investors. Such exceptions when used in times of stress will raise doubts that the BRRD will be robust enough to protect Euro area taxpayers' money.

Further regulatory actions have been implemented recently. European regulators extended the BRRD by setting a minimum liquidity requirement (MREL) for all banks. This requirement is calibrated for each bank individually by national regulators and is to be implemented into legislation in 2019.

On a global level, the Financial Stability Board (FSB), which was established in 2009 at the G20 summit, published standards for the minimum total loss-absorbing capacity (TLAC) of global systemically important banks (G-SIBs) which are to be maintained from 2019. The minimum TLAC can be extended by regulators for individual banks if it is assessed to be necessary for financial stability. These

Germany Prioritizes the Long-term Goal of Sustainability over the Short-term Goal of Revitalizing the World Economy

measures should be transposed in a timely and consistent manner into national law as they help substantially in mitigating the “too-big-too-fail” problem.

No international agreement has been achieved for market-based regulations such as financial transaction taxes or short selling constraints. The main objective of a financial transaction tax suggested by the German government is to dampen potential destabilizing dynamics of high frequency trading. An attempt to establish a common framework in the European area was not successful. However, the European Union allowed eleven of its member states to implement national financial transaction taxes. Short selling constraints have been introduced temporarily during the financial crisis by the USA and other advanced economies to relieve stock markets of the downward pressure due to short selling. The first reasoning against unilateral implementations of such measures is that they distort competition between different economies as well as different asset categories. The second is that under current legislation they affect all traders equally. Therefore, these measures should only be implemented if they are established in all major economies and if they address financial institutions according to the risk they constitute towards financial markets’ stability.

These regulatory actions across the globe were accompanied by an immense supply of liquidity and a zero interest rate policy of central banks across the globe. While the US Federal Bank is about to reduce its “quantitative easing” (QE), the ECB’s operations are expected to be long lasting given the small growth and inflation rates in the Euro area. However, QE does not come without risk. Firstly, low interest rates impair banks’ traditional business models of mobilizing savings and allocating loans to the private business sector and private households as the net interest margins between mobilization and allocation and the possibilities of maturity transformation shrink. This especially affects the large cooperative and savings banks sector, which rely heavily on these more traditional but robust business models, which are especially widespread among German banks. Further, a low interest rate environment encourages risk-taking by economic agents because safe investments are no longer profitable. This increases the risk of asset price bubbles. Therefore, although QE of central banks was necessary to stabilize financial markets when the crisis broke out, now economic reforms need to be implemented to improve the outlook for the Euro area and the world economy as a whole. Monetary policy cannot be a long-term substitute for supply-side structural economic reforms.

3. International macroeconomic policy coordination from a German perspective

Germany, Europe's largest economy and an export powerhouse, has come out of the Great Recession relatively unscathed and currently enjoys strong economic fundamentals. Unemployment stands at a historically low 6.1 percent, while during the Great Recession it never rose above 10 percent. Its GDP is expected to increase by 1.9 percent in 2016, higher than the EU average of 1.6 percent. The economy has an ongoing current account surplus (with a record high of 8.5 percent of GDP in 2015) while federal government finances look more solid, partly aided by the current low interest rate environment and favourable labour market conditions. The debt-to-GDP ratio is projected to fall below the Growth and Stability Pact's 60 percent threshold by 2020.

Germany's economic success can be attributed partly to the wage moderation introduced in the early 2000s, at a time when unemployment was close to 14 percent and some commentators labelled it the "sick man of Europe". The labour market reforms of 2003, undertaken under the umbrella "Agenda 2010", and rising labour productivity have also supported employment growth and improved Germany's competitiveness by reducing unit labour costs. These reforms started a downward trend in German unemployment that was only briefly interrupted by the Great Recession. The success of these reforms is partly shaping the perception of the current crises, explaining the strong German emphasis on structural reforms.

Recent German data indicates that domestic private consumption and housing investment have become the main drivers of GDP growth. This reflects a combination of solid employment numbers, the return of wage growth after years of wage moderation and low consumer price inflation, despite the ECB's monetary policy. In contrast, the contribution of exports to GDP growth has become more muted. The increased reliance on domestic demand to spur GDP growth, if sustained, will be a welcome development since it contributes to reducing global macroeconomic imbalances. Increased government expenditure related to the integration of refugees into the German society will also complement the inward orientation of the economy. However, despite favourable financing conditions due to very low interest rates, the contributions of corporate and public investment to growth have been minimal.

The current global macroeconomic discourse is centred on the slow recovery from the global financial crisis and the need for action involving monetary policy, fiscal policy and structural reforms, coordinated across and within countries. The IMF has repeatedly called for a coordinated response – using monetary policy to raise below-target inflation using available fiscal space to boost public investment and structural reforms to raise potential growth. More recently, the European Commission, which sees Germany's current account surplus as persistently too high, argues that there is fiscal space to boost the currently low public investment without breaching the rules of the Stability and Growth Pact, and that there is

Germany Prioritizes the Long-term Goal of Sustainability over the Short-term Goal of Revitalizing the World Economy

scope for further wage growth without endangering export competitiveness. Such proposals to boost Germany's public investment echo those coming from inside Germany. For instance, the Joint Economic Forecast Project Team, an advisory group to the German government, has recently called for a budget-neutral realignment of fiscal expenditures away from consumption and redistribution and towards investment in human capital and infrastructure.² Even though more public investment on the part of Germany will likely not have large cross-border spillovers it could be part of a collective effort to address global demand weakness while addressing long-term growth challenges through structural reforms.

The narrative coming from German policymakers is that the factors behind the slow global growth are structural. Accordingly priority should be given to structural reforms so as to boost potential growth. Germany's high savings rate and the associated current account and fiscal surpluses are seen as reflections of long-term demographic trends related to an ageing population. There is emphasis on fiscal discipline given the perceived risks to financial stability from the currently high public and private debt levels at the global level. In light of this, the continuation of the ECB's quantitative easing program is seen as counterproductive, discouraging structural reforms by releasing fiscal pressure from governments, and there is little appetite for a globally coordinated fiscal stimulus similar to the G20 stimulus package of 2009. Instead, the German authorities defend the ongoing fiscal consolidation, within the framework of the debt brake rule approved by the German parliament in 2009, as creating room for manoeuvre in response to future adverse shocks. The German focus on fiscal discipline, monetary order and structural reforms and scepticism of aggregate demand management is rooted in the still popular theory of Walter Eucken, a German economist who was instrumental in shaping Germany's post-war economic policy.

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² Joint Economic Forecast Project Group, *German Economy on Track – Economic Policy Needs to Be Realigned. Joint Economic Forecast Autumn 2016*, 29 September 2016, <http://www.cesifo-group.de/ifoHome/facts/Forecasts/Gemeinschaftsdiagnose/Archiv/GD-20160929.html>.

Germany Prioritizes the Long-term Goal of Sustainability over the Short-term Goal of Revitalizing the World Economy

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