LUISS SCHOOL OF EUROPEAN POLITICAL ECONOMY

GERMAN INVESTORS RESHAPING EUROPE

The industrial asymmetry building in the euro area and its political consequences

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Accumulating further current account surpluses, the German industry will be able to shape the Euro-area productions according to its interest and likeliness. On one hand this may be very useful in bringing homogeneity in the currency area, but on the other hand it might carry substantial risks of building a hardly acceptable political asymmetry between Germany and its partners. The risk of indirect political dominance needs to be mitigated by some degree of common industrial governance: primarily equalizing financing costs across the euro area and investing in better human capital in the periphery.

Germany might keep on accumulating current account surpluses

The European Commission recently conducted an ‘In-Depth Review’ of the German economy under its Macroeconomic Imbalances Procedure, concluding that “*Germany is experiencing macroeconomic imbalances, which require monitoring and policy action*”. In fact in 2013 Germany’s current account surplus reached a record high of 7.6% of GDP, the eighth consecutive annual surplus above 6% of GDP. Cyclically corrected estimates show that the structural surplus could be even above 8% of GDP, a threshold that is considered excessive by any standards. The first issue that needs to be considered is whether the accumulation of surpluses in Germany is structural or whether it would taper with time. Apparently, demographic and trade composition factors indicate that Germany will keep on posting high surpluses in its balance of payments for the foreseeable future. Efficient reallocation of excess savings in Germany throughout the Euroarea and abroad is thus essential for growth in the Euroarea and Germany itself.

The accumulation of current account surplus represents a drain of net savings from the trading partners.

On the long term it represents also a source of instability. This was sufficiently demonstrated by the euro-crisis experience that has been at least partially induced by the reckless investments of domestic excessive savings effectuated by the German and Dutch banks. Requests of more balanced political economy has encountered serious resistance in the German government. Essentially, Berlin disputes that its large current account surplus is caused by a relatively sluggish domestic demand and acknowledges only that its main cause is the strong export growth. In fact Germany clearly lagged the rest of the Euro area in terms of the dynamics of domestic demand from the middle of the 1990s until the crisis. In 2013 the German government has fostered more consumption and the new Grand coalition has even introduced some measures that are tapering the cost-advantage of German productions. Since 2010, real income growth has clearly accelerated on the back of a continuing rise in employment and a pick-up in wage growth. Consequently, private consumption has picked up as well, rising on average at an annualised rate of 1.2% from 2009 onwards, compared with just 0.8% from 1999 to 2009. However, the first results of the softening in income policy have been less than convincing. Domestic demand remains subdued and current account remains significantly positive, also as a consequence of the economy's continuing strong export performance. Estimates by DG Ecfin at the EU Commission are reproduced in the table:

Overview of main macro data

		Germany	Spain	France	Italy	Euro area (EA18)
Current account, % GDP	2004-08	6,0	-8,4	-0,9	-1,4	0,3
	2009-12	6,5	-3,6	-2,0	-2,3	0,6
	2013-15	6,7	2,4	-1,6	1,1	2,9
Domestic demand, % y-o-y (1)(2)	2004-08	1,1	3,7	2,2	0,9	2,0
	2009-12	1,0	-3,0	0,4	-1,1	-0,6
	2013-15	1,6	-1,1	0,9	-0,3	0,4
Nominal unit labour costs, % y-o-y	2004-08	-1,1	3,3	1,6	1,9	1,1
	2009-12	2,2	0,3	2,2	2,5	2,0
	2013-15	1,8	-1,0	0,7	1,1	0,8
Export of goods & services, % y-o-y (1)	2004-08	9,9	5,0	3,8	6,1	7,2
	2009-12	3,4	2,9	1,3	0,5	2,1
	2013-15	3,9	5,1	3,7	2,9	3,7

(1) in constant prices, (2) including changes in inventories; arithmetic means for each multi-year period
Source: AMECO (AF13 final)

Once all domestic factors are considered, one should reckon with the eventuality that Germany might structurally remain a source of drain on the euro area savings, at least for the foreseeable time. Other countries will regularly record a debt position, that is a need to attract external savings. The reallocation of German surplus needs to be considered pivotal for the cohesion of the euro area. Both traditional strategies of re-use of the excess savings - financial re-investment and consumption expansion – have not brought convincing outcomes. Financial re-investment of persistent current account surplus has been at best disappointing for German investors. Estimates by the EU Commission reckon with huge losses in portfolio investments at least since 2006. As for consumption, being Germany a very open economy, its multiplier is modest. On the contrary, negative real interest rates provide a very convenient environment for increasing German public investment both domestically and abroad.

The reason why in the past years, domestic investments have been much weaker than it could be expected has largely remained unexplained. In 2012 and 2013, however, Germany recorded between 27 and 29 percent share of total investments in the euro area. These were the highest levels since 2002 after having reached its lowest point in 2007 and 2008 with 22.8 percent. According to preliminary estimates and forecasts by the EU Commission, 2014-2017 will see the relative weight of German investments increase further, but not yet reaching a level more in line with the German share of GDP in the euroarea. If one considers that labor productivity has increased above 1% each year since 2000, potential rate of growth, roughly calculated, should be between 1 and 1,5%, but investment growth in the same period has been less than half that level.

While German investments increase and should definitely do it more, the flip side is the dismal situation in the southern European crisis countries where domestic investors are very reluctant to return. This divergent development should not be surprising. Part of the increasing strength of the German industry is due to its advantages in terms of the costs of financing, relative to other countries in the same currency region. Unfortunately the decline of investments in the periphery is a serious threat for the necessary restructuring of the local industry and for the convergence of the Euro area as a whole. It becomes vital that, given the current financial constraints, German foreign direct investments compensate the void in the periphery and the lack of mobility in the capital markets due to the incomplete banking union and the segmentation of financial markets in the euro area. In sum: if the net savings surplus is destined to continue and cannot be employed, consumed or entirely invested at home, than the best possible solution would be for Germany to invest directly a large part of its current account in the economy of the trading partners.

In fact, the financial advantages of the German companies should remain in place for the foreseeable future, as the traumatic experience of the euro-crisis gets only gradually absorbed and interest rate differentials slowly taper. Consequently, in a ten year horizon German investments may remain more buoyant than those by other Euro partners. They could thus become the single most important factor behind European growth perspectives, although with asymmetric impact on the rest of the euro economy. An impact that will be determined autonomously by the investor, creating a new “industrial asymmetry” between countries of the euro area, after the well-known “financial asymmetry”.

The definition of FDI , foreign direct investment, "refers to an investment made to acquire lasting interest in enterprises operating outside of the economy of the investor," and where "the investor´s purpose is to gain an effective voice in the management of the enterprise." A common practice is to use "a threshold of 10 per cent of equity ownership to qualify an investor as a foreign direct investor." FDI is usefully distinguished from "portfolio investment,[1]" which is foreign investment that is purely financial and does not involve a voice in management and may be quite short-term. It pertains to the traditional structure of German industrial production the engagement of other productive sites in the supply chains. Several studies have proven how the process of industrial contamination that started in the Nineties was reciprocally important for Germany and for Eastern European countries. The question is now whether anything similar might happen with the so-called “periphery”.

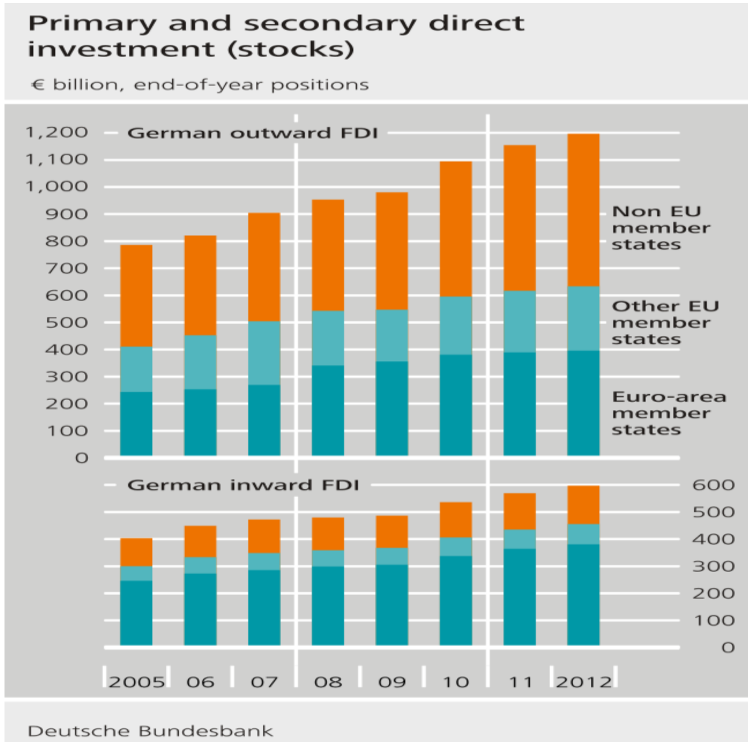
According to Bundesbank data and to a survey conducted by the association of German industrialists, this is in fact what seems to be happening. In 2013, China has been overtaken by the euro area as

1 Unctad report on world investment Spring 2014

primary destination of German investments. This development might indicate a similar process to what happens in the U.S. with the recent repatriation at home of investments that were formerly destined to the Asian emerging economies. In the first decade of the century the buildup of European value or supply chains has developed further. While over 65% of foreign direct investments in Germany come from the rest of the euro area, roughly half of the German direct investments flow to the euro area. In terms of stocks, German outward investments are roughly double as high as those inward. Together with Switzerland, Germany is the greatest provider of invested capital for the euro area. The impact of the economic interconnection derived by the foreign investments is substantial and can change the industrial structure of the euro area. Between 1999 and 2008, according to ECB calculations, on average, around 40% of foreign value added in euro area exports comes from other euro area countries. This means that increasingly we can talk about goods being “Made in Europe” – with the German *Mittelstand* standing at the centre of those supply chains and the larger industrial groups functioning as belleweather of Europe's global initiatives.

In the last year, for the first time since 2010, the Euro area was again the top foreign destination for direct investments by German companies. The share of the Euro area has risen from 40 to 46 per cent - a level not reached previously by any region. According to a survey conducted by DIHK (*Deutscher Industrie- and Handelskammertag)*, one of German association of industrialists, no region ever had improved its share by more than six points within a period of one year and the area of interest is in particular the so-called “periphery”.

Investments by German companies could create employment in the recipient countries, expand their capital stock and raise the level of potential activity. On the medium to long term, this should reduce competitiveness disadvantages and ultimately also reduce the internal imbalances within the euro area. While in the past, current account surpluses were re-invested in financial assets, resorting to direct investments would convert German debt claims on the periphery into equity claims, thereby better aligning incentives on both sides.



According to a rather rosy description given by the Association of German industrialists, German Companies “are strengthening their activities in the EU-15 countries and benefiting as a result from the revival of several states. The hopes of growth as a consequence of efforts to strengthen competitiveness are therefore gradually being fulfilled in these countries. The Eurozone in particular has left recession behind, with investments and employment also gradually being revived again. This is also making the region more interesting as a sales market.”

Especially in the field of automotive construction (rise by 19 points to 50 per cent) among metal producers (rise by 18 points to 55 per cent) in electrical engineering (rise by ten points to 49 per cent) and in the food industry (rise by ten points to 57 per cent), the old EU states are again high up on the list of the destinations where German companies want to bring their investments. The motive of cost savings is one of the decisive factors.

An asymmetric social model

On the long term, should the accumulation of German domestic savings continue and be transposed into direct investments abroad, it could transform the whole industrial structure of the Euro area, making of it a hub system around the German powerhouse. Could it be a politically controversial development? Surely it might.

Considering the political economy effects of an expansion of German investments can lead to controversial conclusions: On the one hand, countries that have comparatively intensive FDI relations also have more synchronized business cycles and can coordinate their political economy more smoothly. Moreover a high level of FDI coincides with an underlying tendency for business cycles to exhibit greater comovement in the future. In this sense, investments could create a politically more homogeneous environment and make of the euro area a more optimal currency area. All in all, however, it is possible that future structural and industrial developments will change the face of the euroarea economy as we know it. Leaving the design of it to private decision makers coming from one single country, may turn out into an escalation of political sensitiveness.

Extending the current statistical evidences to the euro area (destination of almost half of the total German FDI), German companies might invest about 500bn euro in the rest of the euro area in the next decade. This would absorb the total capitalization of entire countries, with significant political consequences. Large chunks of national industries could become a part of productive systems whose decision-makers would remain in Germany.

In order to avoid a political backlash, it would be highly advisable to introduce some elements of common governance in the European industrial policy. Based on the experience of German investments in in Eastern Europe, four conclusions stand out. First, there is a strong convergence effect in productivity, both at the country and at the industry level. Second, FDI inflow plays an important role in accounting for productivity growth. Third, the impact of FDI on productivity critically depends on the absorptive capacity of recipient countries and industries. Fourth, there is important heterogeneity across countries, industries and time with respect to some of the main findings.[2] The distinct effects that neighboring countries can manifest give scope to a function of political arbitrage by the investor. The latter can decide which country is compliant with the framework expected to produce higher yields. In a revealing observation by the German Industrialists association: “The success of the stated reform efforts (it refers to structural reforms announced by single governments) will also be decisive in determining whether the EU-15 countries will be able to defend their top position in the foreign activities of German manufacturing industry.” Not incidentally, FDI to France, where uncertainty about the reforming process became acute, declined by a dramatic 80% in 2013.

The political character of the investors' assessment mirrors the significantly reduced margins of political discretion by the recipient countries. Energy policy in weaker countries, for instance, would be constrained by the necessity to attract investments that are turned away in Germany by an energy policy that is designed to please an environmentally sensitive electorate. Simplifying, nuclear plants might be constructed in the periphery instead than in Bavaria and environmentalists in the periphery will turn against the European project. The fact that labor costs are also a decisive element in moving investments from one country to another gives an idea of how politically sensitive the issue can become in the euro area. According to surveys conducted among German industrialists, investing in the euro area is becoming more relevant for companies also because in some cases they find that the supply of skilled workers there has not been exhausted, while firms face increasing difficulties in finding enough skilled workers in Germany. Among the industrial firms which intend to expand their foreign investments, 37 per cent want to counter the shortage of skilled workers in Germany. The industries which are specifically relocating their production for cost reasons are those which display relatively high energy consumption levels and are simultaneously labor-intensive. The energy-intensive industries of glass, ceramics, stone processing, as well as metal production, are particularly plagued by the high electricity costs in Germany. On the contrary, access to technologies is relatively rarely mentioned by German industrial companies as a reason for their foreign investments even in the EU-15 Member States and in the states of the most recent EU eastern enlargement 2004/2007. Eight per cent only of German firms invest there for acquiring a new technological base, while almost the totality looks for skilled labor at cheaper costs in countries that dispose of a potentially expanding consumer base. Accordingly, the labor-distribution in Europe can create first and second-class societies.

Conclusions

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2 http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp992.pdf

It is difficult to image that a structural asymmetry, enforced by German industrial decision-*makers* and the “rest of the euro area” decision-*takers*, could be politically sustainable. A wide ranging reflection should thus take place about the future of European industry before its current inertial contradiction become unmanageable. Exactly as it has already happened with the financial contradictions – also significantly caused by the German excess savings surpluses – with dire consequences for the whole area.

The European Commission has the power to dictate industrial policy initiatives that could help redesign and even redistribute major factors of comparative advantage, beginning with the energy infrastructures, the digitalization of the small and medium enterprises, specific industrial projects in advanced technologies and the equalization of better human capital in all countries. In the shortest possible time, it is indispensable to bring the quality in the education of national labor forces to similar levels and reduce the differentials in financing costs across the euro area. This could help create the necessary level playing field for individual workers and stave off the risk of popular rejection of the European project.