INET

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The Culprit of the Global Crisis – German Mercantilism!

Prolog

These are truly testing times. The world economic order – capitalism – is being called into question following the Lehman crisis. The world's best form of societal organization – democracy – is being challenged by the economic success of autocratic countries such as China and Singapore. The end of history was proclaimed prematurely by Francis Fukuyama in 1992. Coming up with convincing answers to such challenges requires the greatest effort possible. All my efforts to do this make me ever more humble the older I grow. I find out, time and again, that very much like my doctor, I do not have all the answers.

There is, however, something that makes me – for a German a rare instance – an optimist: my insatiable curiosity. This is my source of wisdom and the ultimate reason for my confidence. I am not in the premier league of the brightest intellectuals, but I am always willing to learn from the brightest. I never stop asking or inquiring. I do specialize (in economics), but remain deeply convinced that associative competences are even more relevant and therefore insist (for myself) on adopting an interdisciplinary interest and approach. My starting point for all analysis is to find out about the true utility function of man, and more than equally important, of woman. It is obvious that we, mankind, do not all tick the same, we seek to maximize either power, reputation or income. And each of the three dimensions of utility is difficult to define appropriately. Is the decision-making unit always to be the individual or a group (for a family: two/three generations)? Which period is it that the economic agent is going to maximize/optimize? Is it a month, a year, a decade or a lifetime?

These considerations are underdeveloped, and not just in economics. Quite a few of us are nothing but "Ichlinge", i.e. persons maximizing individual utility for a very short span of their lifetime (today!). Such an attitude was promoted by the escape from hierarchical coercion exerted by the church, the aristocracy and the patriarchal family. It was the fallout from the enlightenment, degenerating into what I call fundamentalist enlightenment. This form of enlightenment disregards that man comes into existence as a product of "the other", that man is a "zoon politicon". This orientation led economics to limit its focus to the maximization of individual short-term income. This implied disregarding the lifetime perspective, disregarding the environmental concerns arising from human action, disregarding the intergenerational implications of economic choices driven by the maximization considerations described above. Economics degenerated into analysis of the impact (first round effects of action (including economic policy action)). Such an approach disregards the reality that development by its very nature is a game that consist of numerous - if not unquantifiable – rounds.

The 2008/2009 global crisis in short

In the weeks following the Lehman collapse the world economy was at risk of being thrown into a 1930s-like Depression, since consumers and investors in vast parts of the (old) world stopped buying. The risk of a liquidity trap certainly existed. Thus flooding the crisis-stricken countries with central bank liquidity – while it helped to save the financial sector – was probably not sufficient to overcome the crisis, i.e. fiscal stimulation was appropriate: Autumn 2008 was certainly appropriately defined as the perfect Keynesian situation. Fiscal stimulation was effected on a global scale and in very different ways from one country to another. Was this coordination in line with needs and capabilities? The broad answer for 2008/2009 and most countries is a resounding "yes".

The countries best positioned – for very different reasons – responded by and large in a timely and proportionate manner. This is true of both the central bank response and the fiscal action. The FED, the BOE and the ECB were the leading institutions that stepped in as substitutes for the non-functioning money markets of capitalist countries. China, the US and Germany (with a minor delay) functioned as lenders of last demand via fiscal action on the expenditure and taxation side. Other countries – mostly for very good reasons like excessive private and/or public debt – were more hesitant to participate in the fiscal stimulation. While there was an impressive coordinated effort to rescue the global economy from the risk of depression and systemic failure of the financial sector, the efforts to establish the right structure right for sustainable solutions in the financial sector and a more broadly based economic order also geared more towards the environment (i.e. the energy sector) achieved little of the necessary progress.

Thus the fear of a repeat of the crisis plagues the markets, keeping risk premiums high and volatile. The philosophies for addressing the ongoing difficulties differ widely. And the perceptions about the right approach are even wider apart. Germany is depicted as being addicted to austerity as the right solutions, while the Anglo-Saxons are caricatured as being addicted to repeated drug (ab)use (zero interest rates plus fiscal stimulation) to get the world economy going again.

Mercantilism – Dead ever since 1776?

Exports are good – imports are bad? If this is right, then policies to promote growth of exports are as welcome as are instruments to limit imports. This view was already countered by David Hume's Treaty on Trade. Mercantilism was ultimately shot dead by Adam Smith's "Inquiry into the Wealth of Nations", where trade, exports and imports were described as sources to improve specialization and competition, driving the process to better products and production processes – the two avenues to boosting income and wealth.

How then could this mercantilist orientation survive, even in a form of accumulating FX reserves that – apart from bullion – bear the risk of deliberate devaluation?

Mercantilism – old style

Customs duties and quantitative restrictions for imports are the most obvious orthodox instruments of mercantilist policies. Less direct forms are subsidies and other policy support for export industries. A change from an income tax system towards a sales tax (VAT) system is considered an indirect support for such a policy. Other measures with effects favoring a current account surplus are FX interventions to avoid appreciation of one's own currency. This supports price competitiveness. Policies to this effect are to be observed in many countries of the rich/old world in favor of the agricultural sector. Sectors considered to be in their infancy, however, often receive government support to get off the ground. This has been observed with biotech and IT, environmental industries and renewable energy. Often such policies are a result of pressure groups' efforts to protect their clientele, but frequently they do not deliver lasting success and merely saddle government budgets with considerable costs.

Many of the measures described (apart from customs duties and FX interventions) are almost ubiquitous, i.e. they are hardly an explanation of the differences in economic performance of mature industrial countries.

And some countries, especially Germany and most other European current account surplus countries, cannot be accused of policies to obstruct free trade or of misaligning the exchange rate through intervention.

Mercantilism – new style?

So what is it that constitutes this "neo-mercantilism"? How is it described and how is it brought about? Simply speaking any country exhibiting a current account surplus is considered "mercantilist". This is certainly the case, if there is a persistent CA surplus of some order of magnitude, let's say more than 2% of its GDP. Cases in point are Japan, Germany and some smaller European countries (like Switzerland, Norway and the Netherlands).

Table 1	
Current account as % of GDP 20	
Germany	5.6
Japan	2.9
Norway	13.2
Netherlands	6.1
Switzerland	13.0

Sources: National Institutions, National Central Banks, Deutsche Bank Research

Following the current debate it is interesting that the Single Market and the Single Currency – the euro – seem not to be the only sources of what is labelled neo-mercantilism. This appears to provide evidence that points to a multi-faceted explanation. Relative unit labor costs do play a role within the euro area, but the experience of Switzerland and Norway certainly call for other explanations. A lack of appropriate macro policy adjustments is postulated as being the main cause of such disequilibria, i.e. lack of sufficient macroeconomic stimulation is said to be the root cause. And it is said this imbalance is the root cause of other EMU members suffering from persistent current account deficits.

Table 2	
Current account as % of GDP 2010/2011	
Italy	-3.0
Spain	-4.3
Greece	-9.3
United Kingdom	-4.6
United States	-3.6

Sources: National Institutions, National Central Banks, Deutsche Bank Research

Again it is striking that the phenomenon of current account imbalances is anything but limited to the euro area. Two countries with a flexible exchange rate – the US and the UK – exhibit sustainable current account deficits.

This is said to reflect "pro growth" attitudes in both the US and the UK and neo-mercantilist preferences in the table 1 countries, i.e. an anti-inflationary bias or a wage income moderation bias in the countries concerned, labelled "beggar-thy-neighbor"-policies. This is called an employment-oriented bias versus a bias for better catering to the consumer in the table 2 countries. Since such imbalances, if continued, lead to accumulation of reserves in table 1 countries and excessive debt in table 2 countries this is unsustainable with the possible exception of the reserve currency country US.

Before accepting such conclusions the data mining should go a bit deeper. Some of the above-mentioned conclusions would be worth accepting if they did not reflect a snapshot only, but were based on truly lasting phenomena. First, it is obvious that over the last 15 years some countries fall into the category "permanent surpluses", while others do not. Germany was one case that was much more varied.

In the 1990s, the German current account was permanently deep in the red. German real estate prices were far too high, as were unit labor costs due to the effects of unification and a highly pro-growth policy. This led to a debate about the country's lack of competitiveness, and it was even labelled "the sick man of Europe". It is astounding that internationally there is no recollection of something as recent as this.

But not only was the German current account anything but persistently in the black. There is every reason to assume that the imminent dramatic ageing of the German population with its effects on the dependency ratio – which is going to shoot up dramatically in the next 5 to 10 years – will have effects on the current account that can be seen already in Japan, i.e. dramatically shrinking surpluses. At the start of 2012 the Japanese trade surplus, considered by many as an eternal characteristic of Japan's economy has disappeared. While this might be partly caused by temporarily expensive oil (imports) the very fact that the Japanese household savings rate has already trended downward for a considerable period and – due to ageing of the population - is bound to fall further, will result in net exports trending down further. The downtrend in the household savings rate has been speeded up by declining yields on savings because the elderly have to dissave to maintain their spending potential.

Is it mercantilism (German style) if a society prepares for underfunded old age provision by saving more and by investing those savings in assets (financial and tangible) in more vital economies? Such an orientation however implies a current account surplus of countries moving towards a higher dependency ratio in the upcoming decades. Of course such a balance requires a counterparty with complementary properties, i.e. countries with a young and expanding labor force and/or with an economy in catch-up mode. This will enable returns on capital to be higher than in the ageing countries. Many of the countries that have a young labor force and underdeveloped infrastructure and thus have potential for capital to absorb productively are currently plagued with poor governance. Lack of quality administration, insufficient education, corruption, lack of up-to-date physical and IT infrastructure may stand in the way of exploiting the "potential" production potential.

Such a characterization might often fit the situation in developing countries. But some of these developments are to be observed in countries closer to Berlin.

If the savings in ageing societies cannot be invested safely and with a sustainable and good yield in the catching up or developing countries the paradigm of better welfare outcomes as a result of capital flows from Germany to Greece or Egypt cannot fly.

What can help to make this solution fly? The obvious answer is to provide good governance for the societies receiving capital. But how can this work? The societies in question are free to choose their set up. They have to vote and to devise their own government and set of rules. Should the ageing countries interfere with their political process? This is a very difficult question. Freedom and democracy are too important to be traded in for better economic performance. However, I hold the view that attempts should be made to persuade. This might be the role of royal commissions, think-tanks and/or international organizations. This might be the role of partner countries that may have an influence. On occasion it might be particularly helpful to ignite the competitive spirit of a society not to fall behind a neighbor. To illustrate what I have in mind: In the mid-1990s when Spain appeared to be ready to join EMU this very fact was the most powerful motive for Italy to try very hard to fulfill the Maastricht criteria for the Single Currency. Franco Modigliani mobilized every academic and political talent of the Italians at home and in the diaspora to state the welfare-enhancing case of joining the EMU from the start.

<u>Why we should not listen to the siren song of the Anglo-Saxon solution</u>

Before I try to explain why German mercantilism is the solution to the problems currently facing today's ageing countries, I will try to explain why more Keynesianism for ageing societies does not work. To do this I shall attempt to analyze the events that have unfolded in Japan over the last 15 years.

After 1990 the real estate and stock market bubble imploded with a bang and with a yen appreciation that damaged Japan's price competitiveness. Cascades of fiscal stimulus action were set in motion. Tax revenues never came back up. Consumer spending was financed by government cash (borrowed money). Government investment programs were launched. This was expensive, unproductive and thus did not yield (building bridges to uninhabited islands or artistic buildings for waste combustion). The result is an ever-growing public sector debt-to-GDP ratio. During this period no more than 50% of government outlays were ever financed by regular tax and social security revenues. The resulting ever-increasing government debt to GDP ratio is now approaching 250% and its continued increase leaves no scope for a "non-catastrophic" way out. Old-age poverty in my view is unavoidable. And none of those who advised Japan to pursue such Keynesian policies will help. Whether this outcome will follow from a brutal tax increase, a haircut for domestic owners of government assets and/or a devaluation of the yen is open to debate.

Interlude

Since it would appear politically correct to apologize for Germany's mercantilist approach and consequently appropriate to promise revision of one's attitude, I believe it is helpful to "talk the walk".

For that I want to share an episode in my life that occurred while I was attending one of those eminent conferences of the Austrian Central Bank in Baden, close to Vienna in 1978. Three American Nobel Prize winners and one would-be Nobel Prize winner were in attendance. I, by accident, was the one German. I got all the blame for representing a country that was unwilling to accept the "locomotive approach", i.e. the Keynesian answer to the oil crisis. And I stood tall in defense of German orthodoxy, i.e. its anti-inflation stance. (By the way, it took only a short time for Paul Volcker to change the course of US monetary policy while travelling back from the Belgrade IMF meeting.) Anybody who cares to read what I wrote knows that I am certainly not the archbishop of German economic policy orthodoxy. On occasion I have been labelled by the true archbishops as one of the last Keynesians. But as was the case in 1978 there is more to defend in the German economic policy stance than to criticize.

German mercantilism requires complementary action to support good governance in debtor countries

As was the case in 1978 it is wise not to give credence to a black-and-white view of German policies. Back then and post-Lehman German policy provided very active support to international demand. Fiscal action was strong and it was effective. Only very few countries exhibited such strong performance with respect to private consumption and government/infrastructure investment. Strong consumer demand had to do with very smart and stabilizing labor market policy (no redundancies, a shorter working week – accompanied with income support, i.e. a considerable increase in unit labor costs – possible only because of earlier wage moderation!). And even in an ageing society there are investments that may yield high returns, namely investment in health and adult education (more important because of increasing life expectancy). Government measures to support this are welcome as well as measures to improve environment and energy efficiency and the switch towards renewables.

Much of this is in the pipeline even if it does not always have the optimum incentive structure.

But it is not advisable for Germany to listen to the siren song of supporting a higher consumption level now or a big surge of investment in residential dwellings (given the declining population). Instead, Germany should concentrate its efforts on remaining competitive, achieving successful international sales, earning income and saving a good part of it to improve company and private pension provision, preferably by investing in international assets.

As stated before, such strategies can only be successful in the long term if the receiving countries have a high potential growth rate and if they have good governance to effectively exploit their potential.

So, the current attitude of just helping the debtor countries to be in a position to service their mounting debt is necessary but it is not enough. They must also help be helped to help themselves. In a number of circles this need has been translated into calls for a new Marshall Plan.

This debate could be meaningful, if it were to lead to better governance. Many – when talking about a new Marshall Plan for the southern eurozone members – call for increased funding.

This is not the decisive limiting factor. For many years Greece's administrative capacity prevented it from using the funds that were available from Brussels.

The donor countries would do the debtor countries and themselves a favor if they would provide technical assistance to get the governance structure right. The deficiencies are different from one country to the other. I just want to be a bit more specific in the Greek case. Greek needs to invite a battalion of anti-corruption specialists from the US, a legion of privatization experts from Germany, land surveyors from Germany to establish a cadastral land register to enable the effective levying of real estate tax, and skilled personnel from Italy to enhance tax efficiency generally. Greece should welcome Spanish experts to modernize the tourist industry, a sector in which Greece certainly enjoys a natural comparative – if not absolute – advantage. For an interim period Greece should encourage some of its young labor force to work in international companies in order to learn on the job and earn good income that can be partly used for remittances. When international companies better understand the talents of young Greeks they might become far more willing to allocate their FDI to Greece. If this is the idea for a new Marshall Plan, it is exactly what the doctor ordered. Such policies, I am sure, will gain political support and will eventually win over the financial markets. Markets are always very slow to learn. Thus the ESM will be needed in big numbers and for many years. Any hope of a fast correction of market views is not realistic.

This is not all bad. The longer the perception of a euro crisis persists, the slower the upward correction of the euro exchange rate. This will help European manufacturers of aircraft, premium cars and machinery. If this strength is used to enhance energy efficiency and environmental protection this is not bad for Europe and it is good for the world. Europe's demise is certainly not what the world needs. So continue to be proud employees and producers. A good level of consumption goes with it. And you can avoid old-age poverty after 2020/2025!