Institut für Makroökonomie
und Konjunkturforschung
Macroeconomic Policy Institute

Policy Brief

December 2009

From the financial crisis to the world economic crisis (II)

Global imbalances: Cause of the crisis and solution strategies for Germany*

Gustav Horn, Heike Joebges, Rudolf Zwiener

* English version of IMK Report No. 40,
translated from German into English by Katja Rietzler

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Global external imbalances are among the key causes of the current world economic crisis. In the following their relevance will be analysed in detail and it will be shown how they influence the course of the crisis in individual countries. It becomes obvious that Germany is particularly affected due to the great importance of external trade surpluses for growth in this country. A continuation of the one-sided German orientation towards foreign trade cannot be sustainable. Substantial losses of growth and persistent global instabilities would be a threat. For this reason an alternative strategy for a stronger orientation towards domestic markets leading to a balanced and thus sustainable growth is outlined. This IMK Report is the second in a series on the reasons and remedies for the economic crisis (see also: IMK 2009).

One of the roots of the crisis consists in the global imbalances, which had reached historically unknown proportions by 2007. The headline "global imbalances" is used to label the phenomenon observed since the 1990s that one group of countries recorded steadily increasing current account surpluses, whereas for another group of countries the current account deficits kept rising (IMF 2009a, p. 34). Leading deficit countries include the USA, the UK and Spain. China, Germany and Japan can be named as surplus countries (Figure 1).

Via the balance of payments the disequilibria of the goods and services trade are also reflected in capital flows. The deficit countries require capital imports to finance their deficits in their external trade. By contrast, countries with a trade surplus have more capital than is invested in the domestic market, which is thus at the disposal of the world market. This capital supply is seeking investment opportunities in the global financial market. With increasing deficits and surpluses, respectively, there were growing incentives to develop financial market instruments which flexibly managed this enormous capital transfer from surplus to deficit countries. This is exactly what the new financial products facilitated. In this context global mobility of capital and expectations of high yields played an essential role.

The capital flows caused the emergence of an unstable global equilibrium. The USA, the UK and Spain were able to continue their domestic expansion incurring high external deficits. At the same time China, Japan and Germany could maintain their course of an expansion driven by foreign trade, while the domestic economy remained below its potential in China and was limping along in Japan and Germany. Nevertheless, this was an unstable situation, because it rested on a permanently rising net foreign debt of the deficit

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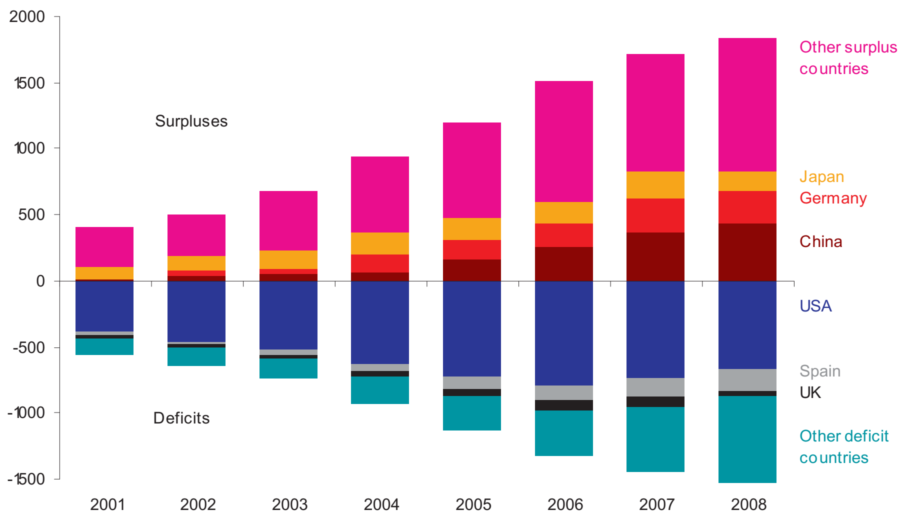
Figure 1

Current account balances in billion US dollars



Annotation: Although surpluses and deficits theoretically add up to zero, this is not the case in practice due to measurement and valuation problems.
Source: Reuters-EcoWin: IMF, WEO, 126 countries.

countries, which would sooner or later reach the limit of creditworthiness.

Meanwhile the associated macroeconomic or even systemic risks resulting from this constellation due to the behaviour of financial market participants are sufficiently known and described (Sinn 2009 and IMK 2009). At the same time the strong capital inflows into the USA have prevented an adjustment via exchange rate alignments. Such an adequate adjustment would have consisted in a significant devaluation of the US currency. Thus, the current account deficit would have been reduced in the course of time, because US exports would have become cheaper and imports into the USA would have become dearer.

In addition to the undesirable developments in the financial markets, which have already been described (IMK 2009), these foreign sector developments contributed to the outbreak of the financial market crisis and the subsequent economic slump. In the following sections the progression and shape of this recession are to be analysed in greater detail for individual economies.

World export champion Germany is hit particularly hard

According to a study by the International Monetary Fund recessions which are accompanied by financial market crises prove particularly deep in industrialised countries and recovery takes a long time (IMF 2009c). Given the historical experience a significant decline in economic activity was to be expected in the wake of the financial crisis (IMK 2007b). Nevertheless, the speed and intensity of the spread to the real economy were startling.[1] Compared to the crises of the last 50 years the current crisis stands out both in terms of its depth and the simultaneity of its effects on countries all over the world. This is true both at the global level, as the International Monetary Fund shows (IMF 2009a, p. 12) and for the OECD countries, as the Bundesbank demonstrates for the example of industrial production, which has declined far more sharply in the current crisis than in earlier recessions which were triggered by financial crises (Deutsche Bundesbank 2009).[2]

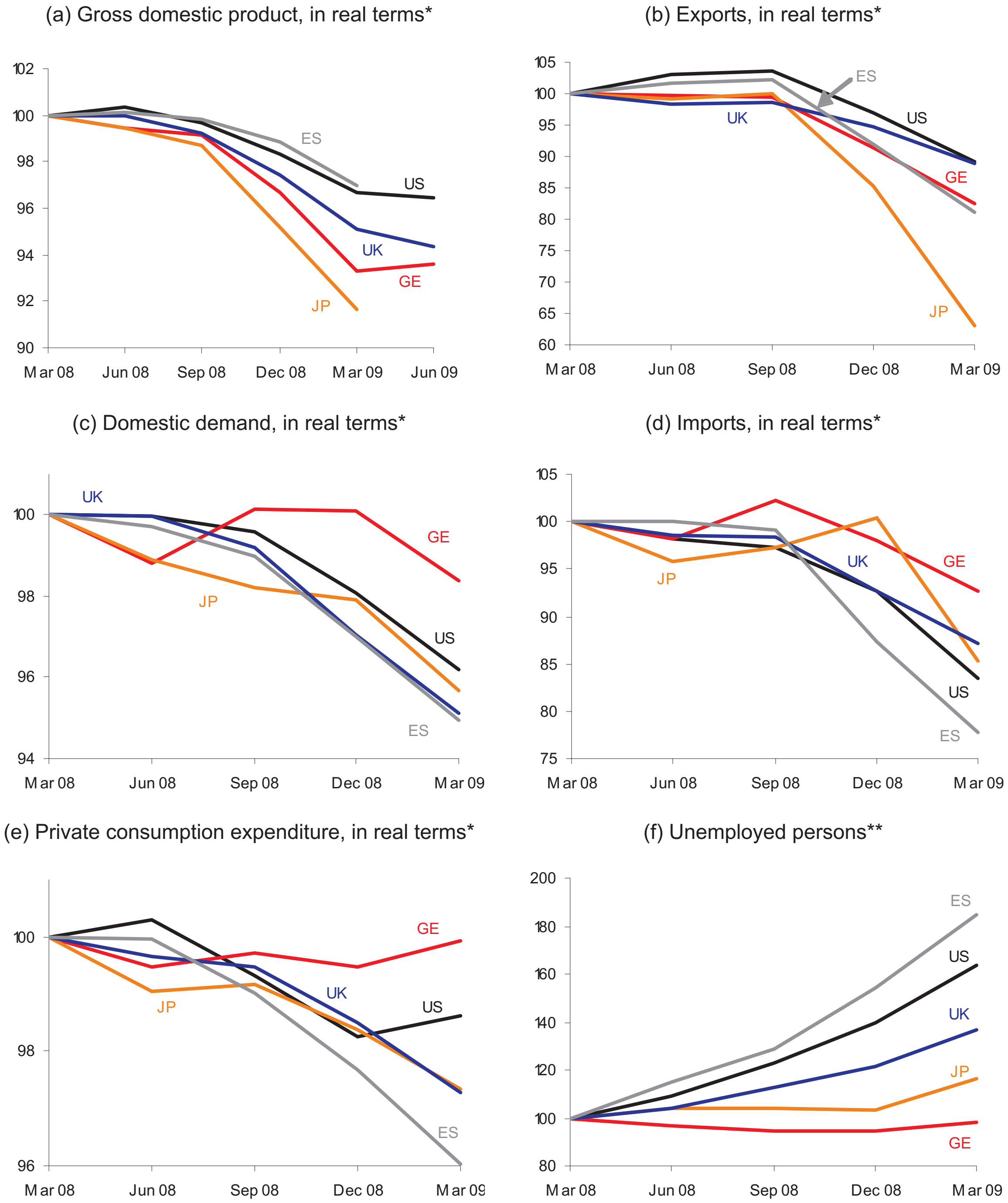
If one compares the effects of the crisis on the real economy in "large" industrial countries, it becomes obvious that export-oriented countries like Germany and Japan are hit particularly hard at the moment: In Figure 2a, GDP at the end of the first quarter of 2008 for a number of "large" industrialised countries is set 100 for

[1] This is why the International Monetary Fund asks „How did things get so bad so fast?" in its Economic Outlook (IMF 2009a, p. 2).

[2] A comparison of the current crisis with the Great Depression of 1929/30 is alarming, as Eichengreen/O'Rourke (2009) show: According to their analysis industrial production has indeed declined at a similar pace since April 2008 as in the Great Depression. However, world trade and stock markets have dropped much faster than in those days.

Figure 2

Effects of the financial crisis on the real economy in selected countries
Total economy, first quarter 2008=100



GE = Germany, ES = Spain, JP = Japan, UK = United Kingdom, US = USA
* Each in the national currency.
** Harmonised data for EU-countries.
Source: Reuters-EcoWin: OECD, GDP-data: national statistical offices, calculations of the IMK.

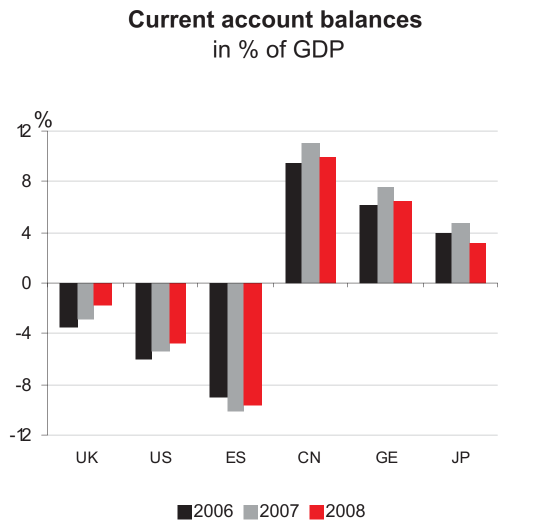
comparison purposes.[3] The focus is on those industrial countries which recorded the highest current account surpluses worldwide (Japan and Germany) and those, which showed the highest deficits (USA, UK and Spain). All these countries observed a strong decline of their economic activity since the middle of 2008. According to the currently available data (end of the first quarter of 2009) the export-oriented countries Germany and Japan have experienced the sharpest decline[4], although both countries – contrary to the other three – are not burdened additionally by problems in the real estate sector. Even the US as the primary origin of the financial crisis is in a better position in terms of growth than Germany. This is striking at first sight.

How can the sharper decline of GDP in both Germany and Japan be explained? The main cause is the different effect of foreign trade on growth: Although all countries in the analysis have suffered from the decline of world trade, the drop in exports was crucial particularly in Germany and Japan: In Japan the drop in exports was strongest of all countries in the analysis at almost 40 %, also because the appreciation of the yen as a consequence of the financial crisis put an additional strain on exports. In Germany, which, being part of the euro area, remained largely unaffected by currency appreciations, the decline in exports proved slightly smaller. However, meanwhile the share of exports in the economy had risen to 50 %, so that the effect on GDP was stronger. With this high export ratio Germany is at the top end of the group of countries analysed; this ratio is only surpassed by those of small open economies.

The decisive factor for the different effects of foreign trade on gross domestic product has so far been the combined reaction of exports and imports: whereas imports declined late and only moderately in Germany and Japan, in the USA, the UK and in Spain the decline in exports was compensated arithmetically by an even higher drop in imports (Figure 2d). Seen in isolation this led to an increase of growth in these countries.

As the current account of the countries in the analysis is above all determined by the trade balance, the USA, the UK and Spain therefore managed to lower their current account deficits in the course of the crisis (Figures 1 and 3). Seen in isolation this had a positive effect on their growth. By contrast, in both Germany and Japan the current account surplus declined (Figures 1 and 3) and slowed down growth.

Figure 3



UK = United Kingdom, US = USA,
ES = Spain, CN = China,
GE = Germany, JP = Japan
Source: Reuters-EcoWin: IMF, WEO.

The fact that imports have so far reacted by less in Germany than in the other countries, can largely be attributed to the relatively stable domestic demand (Figure 2c), which has benefited particularly from private consumption. In a comparison of countries Germany shows the most robust trend of consumption (Figure 2e). This is also due to the fact that the basis has been rather weak due to the considerable underperformance of consumption during the last 10 years. The amazing resilience of consumption in Germany so far may admittedly rest above all on developments in the labour market: whereas unemployment has sky-rocketed especially in Spain and in the UK, but also in the USA, and has caused incomes to plummet, this could largely be avoided in Germany (Figure 2f). Despite the comparatively strong decline in growth, Germany simultaneously observed the lowest increase of unemployment. In addition to internal working time reduction the use of subsidized short-time working schemes has paid off. Thus, the incomes of consumers and consequently consumption remained relatively stable despite the massive decline in production. Another stabilising factor was the "Abwrackprämie" (the German equivalent of "cash for clunkers"), which caused a short-term increase of spending on the purchase of passenger cars.

Despite the faster and more pronounced surge of the unemployment rate in the USA, the consumption

[3] The first quarter of 2008 has been chosen as a reference point, because both German economic growth and industrial production of the OECD countries peaked in this quarter. The GDP of the latter reached its peak only in the second quarter of 2008 (Deutsche Bundesbank 2009, p. 14, footnote 4). According to the assessment of the NBER US growth already peaked in the fourth quarter of 2007. Rebasing the series to the preceding quarter would not alter the quality of the conclusions.

[4] In Germany and Japan industrial production, too, fell more sharply than in the USA (Deutsche Bundesbank 2009).

expenditure in the USA surprisingly declined by less than in Japan. This is probably due to the government's measures to stabilise the economy. Tax refunds for instance have contributed to an immediate stabilisation of incomes. The announcement of measures to stabilise the business cycle, too, has probably prevented rampant pessimism from taking hold of consumer expectations.

By contrast, Japan's consumption was burdened, in addition to unemployment, by negative wealth effects due to exchange rate movements. Many years of a zero interest policy to fight deflation as well as the resulting interest differential with the rest of the world made it lucrative also for Japanese households in the past not only to invest their own funds abroad, but also to borrow in yen for this purpose (so-called carry-trade). As a result of the crisis and of the devaluation of foreign currencies relative to the yen the value of foreign assets declined, while the burden of the loans remained unchanged. Thus, households faced a higher debt burden.

Gross fixed capital formation decreased in all countries. Whereas in Spain, in the UK and in the USA it was construction above all which declined as a consequence of the real estate crisis and thus contributed to a rapid increase of unemployment, in Germany it was primarily investment into machinery and equipment due to shrinking exports. However, the more intense and more timely application of measures to stabilise the economy, which was reflected in higher government spending in Spain, in the UK and in the USA (Figure 4) did not succeed in fully compensating the decline of domestic demand in any of these countries.

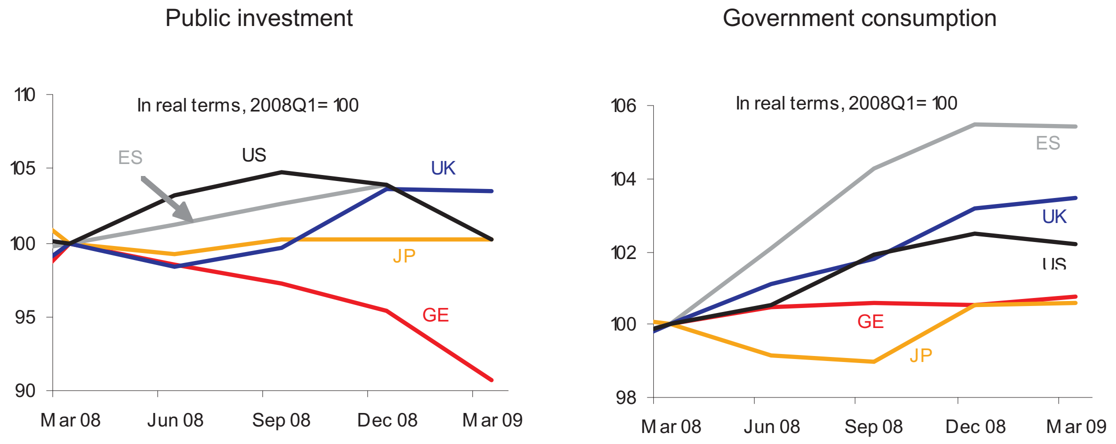
Crisis diminishes global imbalances

The significant increase of the global imbalances took place above all after 2001 and was not slowed until the onset of the financial crisis. The USA, Spain and the UK as well as countries in South, Central and Eastern Europe were among those economies with conspicuously rising foreign trade deficits. Increasing surpluses were reported by China, Germany and Japan as well as the oil exporting countries and other Asian countries. Figure 1 shows the evolution of the current account of the countries with the largest balances in billion US dollars. As can be seen, the USA recorded the highest deficit in 2007 at 731 billion US dollars, surpassing Spain and the UK. Among the surplus countries China is at the top of the list, followed by Japan and Germany.

The high and rising current account deficits could not be sustainable (IMF 2005, Obstfeld/Rogoff 2005, 2007; Godley et al. 2004; Palley 2006). For a rising deficit implies that the country increasingly imports more goods from abroad than it exports itself. At the same time a current account deficit implies that the capital formation of a country cannot be funded by domestic savings (of the private sector as well as the government). As a result this deficit has to be financed by capital inflows from the rest of the world. This increases the assets which the rest of the world is building up vis-à-vis the respective country. Thus, the USA

Figure 4

Government expenditures



UK = United Kingdom, US = USA, ES = Spain, GE = Germany, JP = Japan
Sources: Reuters-EcoWin: OECD; calculations of the IMK.

exchanged their original position of a net creditor vis-à-vis the rest of the world for that of a net debtor. According to a calculation by Brad Setser its net foreign debt had risen to 40 % of GDP in 2007, "... a fairly high level for a country with a modest export sector" (Setser 2009).

In the past exchange rate reactions, which were in fact supposed to work as a price mechanism towards equilibrium, did not only fail to diminish the surpluses and deficits, but contributed to a further increase of the imbalances instead (UNCTAD 2009). For instance the yen devalued against the US dollar from 2002 onwards despite Japan's high current account surpluses, because it was lucrative to borrow in yen to buy higher-yield financial assets in other countries. This caused a further devaluation of the Japanese currency and further enhanced Japan's price competitiveness. Yet, according to the interest parity Japan's negative interest differential vis-à-vis the rest of the world should have reflected appreciation expectations of the yen.

The danger of global currency crises to reduce the external imbalances was stressed by several authors prior to the crisis: "Many observers, including IMF staff, have expressed concern that corrections to sustainable levels will likely require large exchange rate adjustments, especially against the U.S. dollar, with possibly disruptive effects on global financial markets and economic activity" (IMF 2005, p. 109).[5]

The continuous widening of current account deficits and thus of the net capital inflows was not only unusual from a historical perspective,[6] but it was also accompanied by unusually low interest rates in the deficit countries (compared to the surplus countries), especially in the USA.

Some authors explain these with the fact that in many countries savings had not adjusted to the reduced investment activity. They argue as follows: In the industrialised countries capital formation has declined since the Internet bubble burst, in emerging economies this has been the case since the Asian crisis. Since then excess savings of private households has been seeking investment opportunities. For this phenomenon Ben Bernanke coined the term "global savings glut" (Bernanke 2005). As a consequence of the currency crises of the past (especially the Asian crisis) emerging economies felt compelled to achieve current account surpluses. This was often accompanied by building up currency reserves to avoid appreciations of the currency. High commodity price increases furthered current account surpluses in oil exporting countries. The huge capital inflows from emerging economies into the USA led to exceptionally low long-term interest rates and an asset price bubble there.[7] Both provided an incentive for Americans to consume more and save less. At the same time the ensuing dollar appreciation made exports more expensive and imports cheaper (Bernanke 2005, 2007).

A series of attempts to interpret the high US current account deficit as stable were debated under the headline "Bretton Woods II". It was argued that due to its extensive assets in US dollars China had a particular interest in this constellation and would, via sufficiently high capital inflows into the USA, ensure that the US current account deficit could be financed without a stronger devaluation of the US dollar or, respectively, a stronger appreciation of the Renmimbi (Dooley et al 2004; Caballero et al. 2008; Cooper 2008). However, according to Blanchard/Giavazzi/Sa (2005), on the one hand this argument ignores the long-term requirement of a devaluation of the US dollar due to rising external debt. Such expectations should indeed have become obvious in the current exchange rate. On the other hand all these arguments underestimate the fact that it was the credit-financed consumption expenditure (of the government and the private sector), which generated the demand for the high capital inflows in the USA (IMK 2009; Papadimitriou et al. 2002; Palley 2006).

The increase of the global trade imbalances would not have been possible, if the globalisation of financial markets had not facilitated their financing at the same time: "Overall, financial globalization has created an environment where net external borrowing and lending are less restricted and where maintaining larger net foreign liabilities appears to involve relatively lower costs" (IMF 2005, p. 109; see also: Obstfeld/Rogoff 2005).

Brender and Pisani (2009) point out that it is not sufficient to refer to the globalisation of financial markets, because it cannot explain why the increase of deficits has accelerated above all in the current decade. The liberalisation of capital markets took place much earlier. However, the internationally observed "transfer of savings" from emerging economies to in-

[5] Calculations of the necessary devaluation of the US dollar are provided by e.g. Obstfeld/Rogoff (2005). The authors assume that the US dollar would have to devalue by 29-60 % to halve the trade deficit – depending on whether the Asian countries accept an appreciation of their currencies vis-à-vis the US dollar or not. In the latter case the euro would bear the main adjustment burden. Blanchard/Giavazzi/Sa (2005) partly calculate higher devaluations of the US dollar.

[6] Merely during the Gold Standard there was a phase of similarly high relative imbalances (IMF 2005, p. 118ff).

[7] Until the internet bubble burst, mainly American stocks benefited, afterwards this was true for the real estate sector.

dustrialised countries did not intensify until the 2000s – parallel to strong growth in the emerging economies.

Capital inflows from emerging economies were mainly invested in low-risk assets such as government bonds. This implies that the risky assets were primarily bought by investors from the industrialised countries themselves. The risks thus remained within the group of industrialised countries (Brender/Pisani 2009, chapter 4). This, de facto, riskier behaviour, which was accompanied by an increased leveraging of loans (IMK 2009), "... has permitted the 'transformation' of some $ 5,000 billion of emerging countries savings, invested largely risk-free, into loans to Western households and firms, risky by nature" (Brender/Pisani 2009, p. 77).[8]

This also explains why the increase of the global imbalances had not been slowed by expectations of currency turbulences (above all in the shape of a dollar crisis), but decelerated only when the financial crisis set in (Figures 1 and 3). Admittedly, a certain reduction of the US deficit had already started slightly earlier due to the economic slowdown. In addition, the weakening growth in the USA directly and indirectly diminished the export potential of many countries. However, the financial crisis enforced a decrease of the balances worldwide via the following mechanisms (see also IMF 2009a, p. 36):

- Due to the financial crisis the wealth of private households shrank – both because of the losses of financial assets and the fall of house prices (IMF 2009b, p. 66ff). This had a negative effect on their consumption expenditure and reduced consumption-induced imports. In addition many households had to reduce their debt. This affected particularly the USA, the UK and Spain, who had the highest current account deficits.
- In the wake of the financial crisis borrowing conditions were tightened worldwide and in particular for cross-border transactions, which impeded the financing of imports.
- The financial crisis was also accompanied by a drop in previously surging commodity prices, especially for oil. This reduced net exports of the oil exporting countries. At the same time the (nominal) imports of commodity (oil) importing countries diminished due to lower prices.
- In times of fast rising commodity prices speculation-induced excess imports probably took place in a number of countries. Therefore, excess inventories and consequently imports were reduced in the initial phase of the crisis.

The world economy after the crisis: the return of "business as usual"?

The future trend of the individual countries current account balances largely depends on national or internationally coordinated policy measures to overcome the crisis. Their effect on the savings and investment ratios in the individual countries will be crucial.

In any case a return to the previous global imbalances is unlikely: at least the countries exhibiting the highest current account deficits, the USA, the UK and Spain, will not be able to sustain such high deficits in the near future:

- In all three countries private consumption expenditure is retarded by wealth effects: on the one hand financial assets have lost substantial value, on the other hand real estate prices will not climb back to the high pre-crisis levels.[9] In addition to the burden of non-repaid mortgage loans many households in the USA and in the UK had propped up their consumption with consumer credits secured by the (rising) value of their property, while real incomes stagnated. Continuing this practice is likely to be difficult in the future.[10] In view of the necessary reduction of debt (especially in the USA) the higher savings of private households which have been observed since the onset of the crisis are likely to persist for the time being. This will weaken the consumption-induced imports of these countries for a long time.
- Not only private households, but also businesses in the USA and in the UK are indebted. In the USA gross debt of the private sector (households and businesses, excluding the financial sector) had risen to 180 % of GDP prior to the crisis. Its reduction will take a while and dampen their spending.

Against this background the growth rates of these countries are likely to remain subdued for years. Thus, the growth of their imports, too, will remain below average for years. The partly dramatic downward adjustments of imports during the crisis support this expectation. Even if these countries wanted to increase their imports again, a renewed financing of the current account deficits by foreign investors will no longer be possible at the previous conditions. The crisis has enhanced the risk awareness of foreign investors. Despite the recent recovery, trade in certain financial market products will not reach its pre-crisis level again. An

[8] The fact that external assets of the USA tended to consist of high-yield and high-risk financial products, while their external liabilities tended to consist of low-interest and low-risk financial products, is also stressed, among others, by Obstfeld/Rogoff (2005).

additional factor is the increased devaluation risk. This is particularly true for the USA, but also for the UK. Being part of the euro area Spain is likely to have the least difficulties in raising its foreign debt.

This means that the USA cannot be counted on as the growth engine of the world in the near future. In the past its willingness to accept high current account deficits had enabled particularly emerging economies, especially in Asia and Central and Eastern Europe, to spur their growth via rising exports to the USA. The UK and Spain, too, will have to reduce their current account deficits.

So far there have not been any signs that other countries are willing to step in. Above all there is no evidence of any willingness of the current surplus countries – China, Japan and Germany – to facilitate a significant increase of their imports. The present reduction of their current account surpluses has been enforced primarily by a drop in exports due to the crisis. Consequently, for the longer term, the IMF forecasts a renewed slight expansion of the current account imbalances compared to their ongoing reduction in the wake of the crisis, but no return to the pre-crisis levels. This view is also supported by the fact that fiscal policy is likely to adopt a long-term consolidation course, which will put a strain on the respective economies for years to come. According to the IMF's forecast the US current account deficit is expected to stabilise at 3.5 % of GDP initially (2010/2011) and decline to 2.25 % in the long run (IMF 2009a, p. 38). Countries with a current account deficit such as Spain and the UK will remain in deficit, albeit at a lower level. Equally the surplus countries such as Germany and Japan will be able to achieve only lower net exports. Only for China the IMF assumes even higher surpluses in billion US dollars than before the crisis. For all other countries smaller balances are expected.

What does this mean for Germany?

In the coming years the world economy will be very likely not to observe the high growth rates any more that were achieved just before the crisis. In addition to a slower trade expansion banks will remain burdened with risky assets for some time, which is expected to dampen their lending. For private households losses of wealth and the consequences of higher unemployment will have a negative effect on consumption. In addition the expected decline of government spending is likely to have a retarding effect, because all industrialised countries will try to adopt a course of budget consolidation.

For a country like Germany, which achieved a substantial part of its growth via external trade in the past, this constellation calls the practice of the latest decade – of an almost exclusively export-based growth – into question. A complete elimination of the external deficits in the USA, the UK and Spain, the leading debtor countries, would ceteris paribus imply a negative growth impulse of 3 percentage points for Germany. If we assume a more realistic reduction of two thirds of the deficits the negative influence would shrink to 2 percentage points (see box: "Effects of the import reduction on the German economy"). That means: all other things being equal growth in Germany would be substantially dampened.

Three scenarios seem possible, which will first be explained from a national perspective in the following section, before the consequences for the euro area will be discussed:

1) "Business as usual" – despite the changed environment,
2) an even "more aggressive export strategy" than in the past,
3) "balanced growth".

1) "Business as usual": Germany – as is apparently assumed by the IMF – continues its current economic policy strategy even in a changed environment. In the medium term this would imply an even weaker growth than before the crisis, because the export performance of the recent past would by far not be achieved again given the weaker expansion of the world economy. The average growth rate already proved rather moderate in the decade before the crisis. Thus, the outlook is none too bright: the new level of unemployment which is to be expected in the wake of the crisis will be 4.7 million people at the end of 2010 (Hohlfeld et al. 2009) and is not likely to be reduced at these low growth rates. Government debt will remain high. Due to the "debt break" which has been introduced into the German constitution the government cannot apply fiscal measures to counter this development. This increases the pressure on the government to cut spending in the social sector and – on the local governments – to cut investment. Further social spending cuts and a continuation of the slump are looming. At the same time weak growth, worsened export conditions and high long-term unemployment will cause an increased pressure on wages. A rise of income inequality and deflationary tendencies are to be expected. Due to a lack of world demand net exports will not, as in the past, rise from year to year. Thus, the usual source of growth will dry up.

Effects of the import reduction on the German economy

This analysis serves to quantify the negative growth impulses which a reduction of the global imbalances would cause in Germany. For this purpose the effects of a reduction of imports are estimated for the three countries with the highest current account deficits – i.e. the USA, the UK, and Spain – starting at their peaks of 2006 and 2007. In a first step the deficits of these countries are presented in Table 1 weighted according to their shares in German exports in US dollars (Deutsche Bundesbank 2008, p. 41). The weights reflect both the direct trade between Germany and the respective country and the indirect effects via third countries.[11] Subsequently the amounts are calculated in euros and finally set in relation to GDP. This is carried out for 2006 and 2007 both for the case of a complete elimination of the deficits and for the case of a reduction to one third of the original level.[12] If the three countries in the analysis reduced their imports to an extent which would enable them to eliminate their current account deficits, a negative growth impulse of about 3 percentage points would result for Germany. A reduction of the current account deficits to one third of their initial level would still entail a negative impulse of two percentage points.

Table 1

Effects of a reduction of trade deficits

	1	2	3	4
	Weighted deficits in US-dollars	in Euros	in % of GDP	Reduction to one third
USA				
2006	-88,3	-70,3	-3,03	-2,02
2007	-81,9	-59,8	-2,47	-1,64
UK				
2006	-6,7	-5,4	-0,23	-0,15
2007	-6,5	-4,8	-0,20	-0,13
Spain				
2006	-4,0	-3,2	-0,14	-0,09
2007	-5,2	-3,8	-0,16	-0,10
Total				
2006			-3,39	-2,26
2007			-2,82	-1,88

Column 1 weighted according to Deutsche Bundesbank (2008).
Sources: Reuters-EcoWin: WEO, Eurostat; calculations of the IMK.

[11] However, the Deutsche Bundesbank calculates these weights only for the trade of goods. In the light of Germany's above-average exports of services to the USA and the UK the actual importance of these countries for Germany's exports is thus even under-estimated.

[12] The calculated impulse is likely to be underestimated, because third country effects of the reduction are probably measured only in part. At the same time it is overestimated, because export-induced imports, which would then partly disappear, are not taken into account.

2) A "more aggressive export strategy": Germany continues to rely on exports as a growth engine. To achieve high net exports in a worsened environment the pressure on employees for wage moderation is increased. Accompanied by institutional reforms of the labour market there are attempts to lower labour cost enough to aggressively gain rising export market shares at the expense of other countries. Exports can thus fulfil their function as a growth engine, albeit with an increasingly weakened domestic demand, a declining wage share and an increasingly unfair distribution of income and wealth. Precarious employment will further gain weight. Sooner or later destabilising foreign trade surpluses will re-emerge. These will, all other things being equal, raise growth in Germany, but not to the previously observed extent, because the domestic economic weakness is exacerbated due to increased pressure on wages. At the same time the seeds are sown for the next crisis in the euro area.

3) "Balanced growth": Germany changes its strategy and tries to strengthen the domestic economy. A study by Joebges et al. (2009; see box "Higher growth and lower trade surplus with productivity-oriented wage-growth") shows that this would pay off. It can indeed be shown that Germany benefited from globalisation in the past. The good export performance did not only contribute to an accelerated growth, but it also helped to create more jobs than were lost due to off-shoring and imports of intermediate products.

But, as the authors show, even before the crisis a strategy of strengthening the domestic economy would have been more successful: Higher wage increases would admittedly have led to lower exports and higher imports, but private consumption and domestic demand would also have shown a better performance because of improved purchasing power, also resulting from higher employment. In view of the size of the German economy the growth in domestic demand

Higher growth and lower trade surplus with productivity-oriented wage growth

The analysis focuses on the effects of a wage trend which follows the price trend and the average productivity growth. It covers the period since the beginning of the European Monetary Union (EMU) in January 1999. For, due to the EMU, changes of the wage level no longer trigger any adjustments of the nominal exchange rate. Before the monetary union the relatively low wage increases in Germany indeed led to initial current account surpluses. However, the initial competitive advantage was repeatedly lost and in part even overcompensated because of appreciations of the D-Mark. Since the beginning of the EMU, however, the low German wage increases have been equivalent to permanent and cumulative real devaluations.

Contrary to the low wage increases of the past decade (Horn/Logeay 2004) the simulation assumes a productivity-oriented wage trend: the benchmark is a combination of the medium-term productivity growth (1 % per employee annually from the beginning of the monetary union to the financial crisis) and of the ECB's target inflation rate of slightly below 2 %. Wage increases of about 3 % for the economy as a whole would neither violate the ECB's target for price stability nor would they cause Germany to lose competitiveness within the EMU. However, the ECB might be forced in certain periods to tighten its monetary policy to ensure that the target is met, if some member states – other than Germany – behave contrary to the stability requirements. This is taken into account in the simulation. In addition the expenditures for transfers to households, government consumption, and public investment have been adjusted for the improved revenues and nominal GDP growth. The model simulations ensure that the budget deficits in the scenario with higher wage increases are similar in size as in the baseline simulation.

The simulation is run with the IMK's macro-econometric model. This model is permanently updated and re-estimated. It is used for various analyses (IMK 2007a, IMK 2007b and Horn et al. 2008). The purpose of the simulation is to shed light on the question, how – compared to the actual development – higher wage increases affect economic growth, employment and in particular external economic relations. A detailed description of the simulation can be found in Joebges et al. (2009).

If nominal effective wages (per employee) had been increased according to the benchmark outlined above since the beginning of EMU, the wage level per employee would by now be more than 17 % higher than in the baseline simulation (Figure 5). The resulting price increases – the price level would have been 6.5 % higher after nine years – would partly have offset a corresponding increase in real wages. However, real wages would at least have risen faster, by about 11 %. In actual fact, however, real wages per employee declined by nearly 4 % during that period, if calculated with the private consumption deflator.

There would have been an additional boost in real private consumption of slightly more than 3 % during those 9 years. It would have grown much faster than by the actual 5 ½ %. Overall economic growth would have performed somewhat better: real GDP would eventually have been more than 1 % higher. This would also have induced an increase of employment of almost 1 % (Figure 5). The government, too, would have benefited from the wage increases and the subsequent price increases via higher revenues.

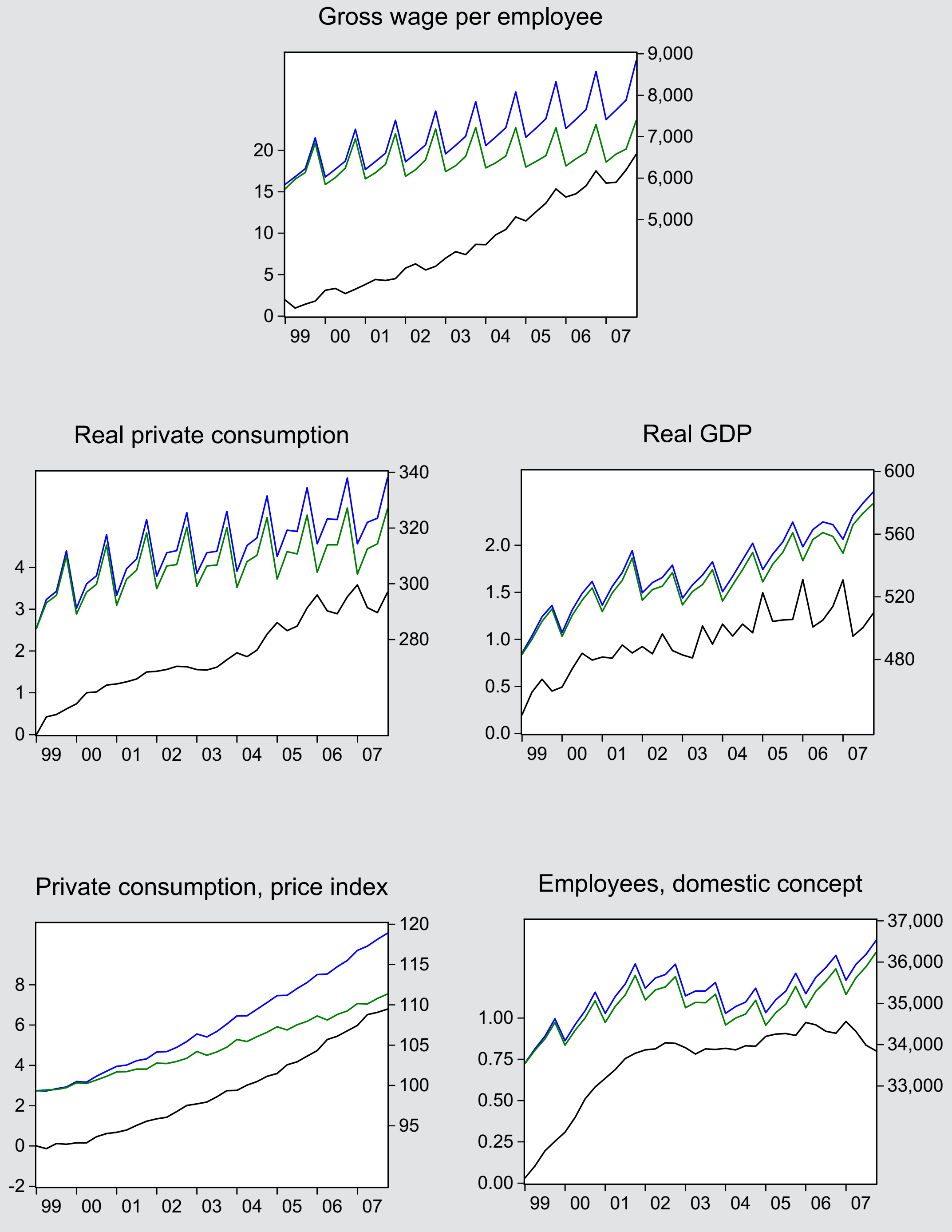
A particular focus is on the effects of higher wages and, consequently, a worsened competitiveness on foreign trade (Figure 6). The higher unit labour costs are only partly passed through in export prices. After nine years they exceed the level of the baseline simulation by only 5 %. At the same time the increases in real exports are about 5 % lower.

The induced increase in import prices (roughly 4 % above baseline) is explained by the fact that in view of the higher domestic price level importers do not fully make use of their potential to pass lower prices through to consumers. The concept of "pricing to market" is not only applied by German exporters, who orient themselves towards the price level of their respective markets, but also by importers in Germany. According to the simulation of a stronger wage increase, imports rise by an additional 3 %. Thus, on balance, net exports are 35 billion euro lower after 9 years.

Figure 5

Macroeconomic effects of higher wages

Deviation from baseline simulation in %

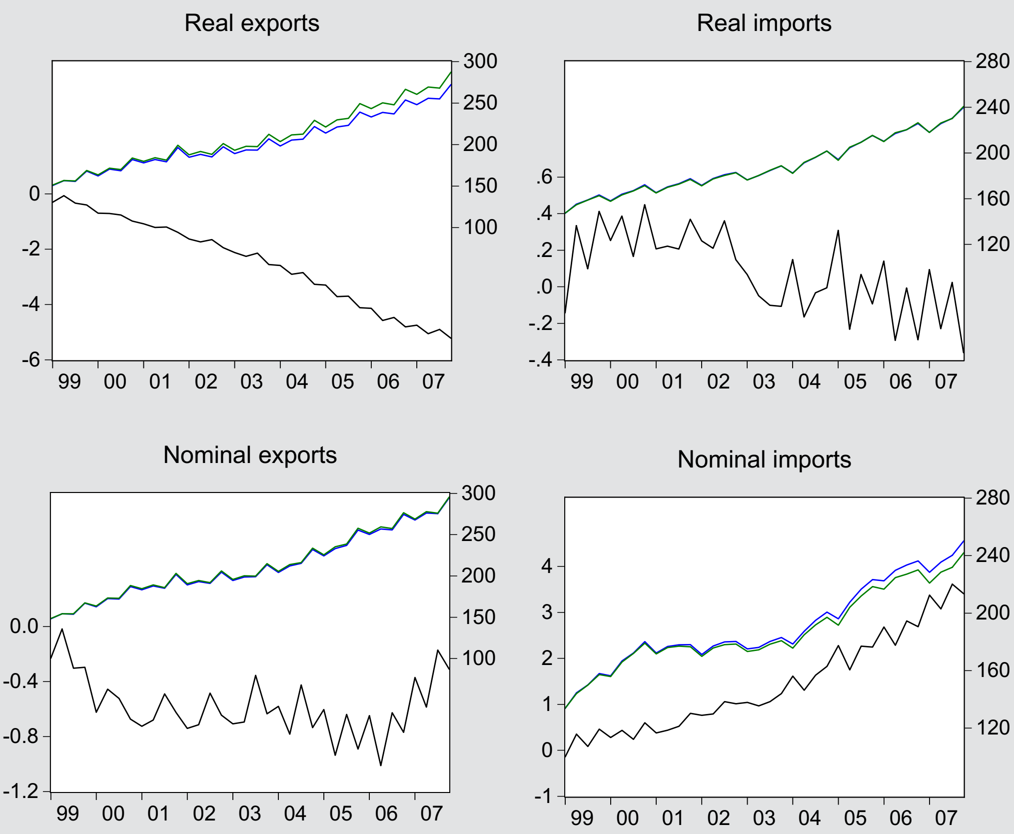


Annotation: The green line shows the evolution in the baseline simulation (right axis), the blue line, by contrast, shows the results of the simulation (right axis). The deviation in % is given by the black line (left axis) below.

Sources: Destatis; own calculations of the IMK.

Figure 6

Effects on foreign trade
Deviation from baseline simulation in %



Annotation: The green line shows the evolution in the baseline simulation (right axis), the blue line, by contrast, shows the results of the simulation (right axis). The deviation in % is given by the black line (left axis) below.
Sources: Destatis; calculations oft he IMK.

would have over-compensated the losses in foreign trade: growth, wages, income distribution and jobs would have shown a much more favourable trend. At the same time the destabilising foreign trade surpluses would not have emerged.

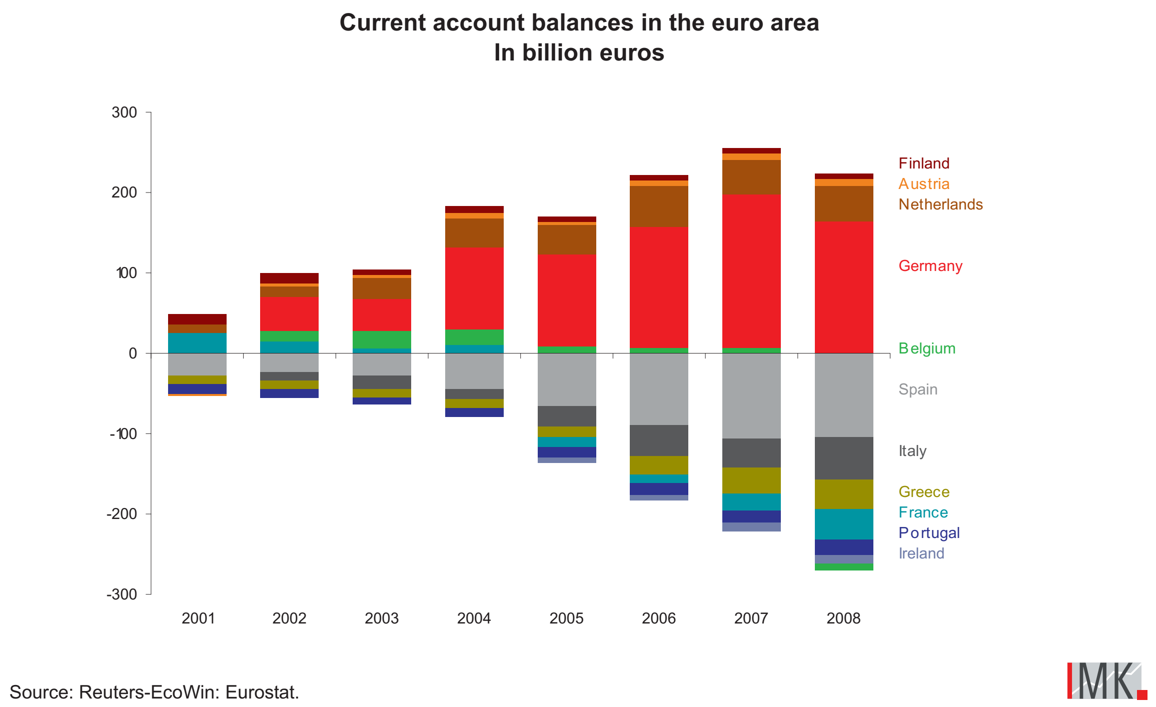
The necessary requirements for a strategy geared more to the domestic economy would be:

- A return to productivity-oriented wage increases,
- the introduction of a statutory minimum wage, to reduce the erosion of the wage-formation process at the bottom end (Logeay/Zwiener 2008; DIW 2009),
- higher government investment,
- support for private investment into the real economy – both via tax incentives, which make investment into the real economy more attractive than financial investments (e.g. by means of a financial transactions tax), as well as via a reduction of incentives to acquire financial assets (e.g. by abolishing subsidies to the "Riester" and "Rürup" pension schemes, the abolition of the proportional capital gains tax in favour of a taxation based on the progressive individual income tax rate etc.).

The impact on the euro area

Imbalances do not only exist in global foreign trade, but also within the euro area: until the onset of the crisis, growing current account deficits in Spain, Italy, Greece and France were matched by rising current account surpluses in Germany, the Netherlands and

Figure 7



Source: Reuters-EcoWin: Eurostat.

Austria (Figure 7). Unlike in the global context these imbalances cannot be reduced via changes in the national exchange rate. The countries with current account deficits have lost competitiveness since the beginning of monetary union, because their wages have grown faster and their inflation rates have been higher. They can only improve their competitiveness, if they record lower wage increases than Germany or even decreases. Exceptionally high productivity growth would be an alternative to gain competitiveness (Horn et al. 2005; Flassbeck 2007; Fritsche 2009).

In the past they did not succeed. If Germany continued its practice of boosting its exports by means of low wage increases, in other words by means of a real devaluation vis-à-vis the other euro area countries, the deficit countries' prospects for a reduction of their deficits would be very limited. However, due to the importance of the euro area for the German exports this would have negative repercussions for the German economy: neither a break-up of the euro area (Flassbeck/Spiecker 2009), nor a permanent economic weakness in the affected euro area countries would be in Germany's interest. Thus it is obvious, from a European perspective alone, that the first two strategies outlined in the previous section cannot be sustainable. Solely the strategy of strengthening domestic demand in Germany would relieve the deficit countries in the euro area and would thus also be sustainable. Therefore this strategy offers two advantages:

1) Germany itself would have somewhat better growth prospects.
2) Germany would simultaneously contribute to the stabilisation of its deficit-ridden trade partners in the euro area.

From a global perspective, too, only this strategy can be successful, because Germany, like China and Japan, will be unable to escape a commitment to support world economic stability.

Recommendations for a change of direction in economic policy

By international comparison the German economy is hit particularly hard by the crisis. This is so, because it concentrated its growth strategy on exports during the past decade, so that the fall in exports is more painful than in economies where a strong domestic demand can absorb such a shock much better. Furthermore, Germany's constantly rising trade surpluses have contributed to the destabilisation of the world economy, driving other economies – particularly in the euro area – out of the markets by means of permanent real devaluations due to low wage increases.

At the same time parts of the capital exports resulting from trade surpluses were invested into risky financial assets particularly in the USA. Meanwhile they have become nearly worthless. Thus the fruits of the export success are lost and they will not grow again in the near future. In the world economy of the future, where deficits and surpluses in trade balances will be smaller, German growth rates will tend to be much lower all other things being equal. The key challenge the German economy is facing consists in finding a new stable growth path. Both from a national and from an international perspective this can only be a path of balanced growth, where the domestic demand has more weight than in the past.

The contours of a changed world economic structure will emerge only gradually from the turmoil of the financial crisis. Then it will become obvious that the present practice of the German economy to generate growth almost exclusively via net exports will no longer be an option due to changes in the markets and the necessity to preserve global economic stability. This does not mean that exports will have to be reduced, but that in future imports to Germany should evolve parallel to exports. A reduced integration of the German economy into global economic structures is not the issue. On the contrary, the objective is a sustainable stabilisation of the latter.

To achieve it, economic policy both in Germany and in the rest of the world will have to break new ground. A change of course is not a mechanical, but a political process. In Germany a growth path, which is balanced between export demand and domestic demand must be aimed at. This is possible only, if economic policy abandons the promotion of ever rising international competitiveness. Gaining and sustaining competitiveness is the task of businesses and the social partners, via productivity-enhancing investment or adequate wage agreements. There is no need for permanent additional economic policy interventions for this purpose.

On the contrary, economic policy in Germany has to ensure that macroeconomic objectives in terms of growth, employment, price stability and an external balance are met. For this purpose Germany needs a stronger support of domestic demand in the near future, which will have a positive effect on imports and increase global stability as required. This can be achieved in different ways. On the one hand wage erosion at the bottom end of the scale has to be contained and unwelcome trends in the income distribution have to be corrected (Logeay/Zwiener 2008). This may be achieved by means of an introduction of a general statutory minimum wage.

On the other hand both public sector and private sector investment is too low in Germany. This leads to a decay of public infrastructure and prevents the investments which would be necessary to provide a sustainable energy supply, to cope with climate change and to prop up the inadequate education system. All of this hampers productivity and consequently prevents the emergence of private prosperity. In order to obtain a change of course fundamental fiscal policy decisions in terms of tax law are necessary. With respect to the required tasks the German public sector is essentially underfinanced. Against this background general tax cuts are not an option. This does not rule out changes in the tax structure. Much rather, after the crisis, higher taxes must be levied, which should then be used for public investment to strengthen domestic demand. Furthermore, the incentives for real sector investment should generally be enhanced in the tax code, while financial market transactions should be taxed. With this general change of course Germany is more likely than before to fulfil its responsibility both for growth and prosperity in Germany and for the stability of the world economy.

However, the latter also requires economic policy efforts on a global scale. Stability can only be expected, if there are globally valid agreements on the regulation of financial markets and if foreign trade imbalances can be avoided in the future. To meet this objective not only financial markets but also the world exchange rate system must be reformed, because the existing system with its flexible key currency, the US dollar, has not succeeded in avoiding the emergence of imbalances. The key reform task of the coming years is to establish these principles. Otherwise, additional crises entailing substantial burdens for the economies are highly probable.

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