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FINANCIALISATION · ECONOMY · SOCIETY · SUSTAINABLE DEVELOPMENT

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Finance-dominated capitalism in Germany, deep recession and rapid recovery

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Presentation for the conference
“Inequality and the Future of Capitalism”
of the FMM research network,
01 November 2014

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Content of the presentation

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2. The effects of financialisation
    1. On distribution
    2. On investment
    3. On consumption
3. The effects on the current account
    1. An overview
    2. Why did net exports explode in the 2000s?
4. The financial crisis in Germany
5. Conclusions

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LONG RUN DEVELOPMENTS IN GERMANY

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Long run developments in Germany

- Changes in Germany leading to an increasing importance of finance in Germany in the 1990s:
  - General push for the development of financial markets, which were hitherto undeveloped in Germany by big banks and government
  - Different legislative measures to support development of financial markets
    - E.g. 4 financial market promotion acts since the 1990s (Abolition of the stock exchange tax (1991), Legislation regarding share buy backs (1998), Abolition of capital gains tax (2002), Allowance of Hedge Funds (2004))

- **Resulting in**:

→ Emergence of a market for corporate control
→ Dissolution of parts of the German company network
→ Increased foreign and institutional investors as owners of German non-financial corporations
→ Increased activity of Hedge and Private Equity Funds

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Long run developments: Growth contributions

	1961 - 1966	1967 - 1974	1975 - 1981	1982 - 1992	1993 - 2002	2003 - 2008	2009 - 2013
Real GDP growth, per cent	4.49	3.82	2.40	2.77	1.40	1.59	0.66
Growth contribution of (percentage points)							
domestic demand including stocks	4.49	3.59	2.36	2.52	0.93	0.94	0.58
private consumption	2.47	2.25	1.55	1.42	0.72	0.28	0.60
public consumption	1.03	0.84	0.70	0.21	0.28	0.17	0.26
gross fixed capital formation	1.28	0.47	0.38	0.69	0.04	0.40	-0.10
change in inventories and net acquisition of valuables	-0.29	0.03	-0.28	0.20	-0.11	0.10	-0.19
the balance of goods and services	-0.01	0.23	0.04	0.25	0.47	0.64	0.08

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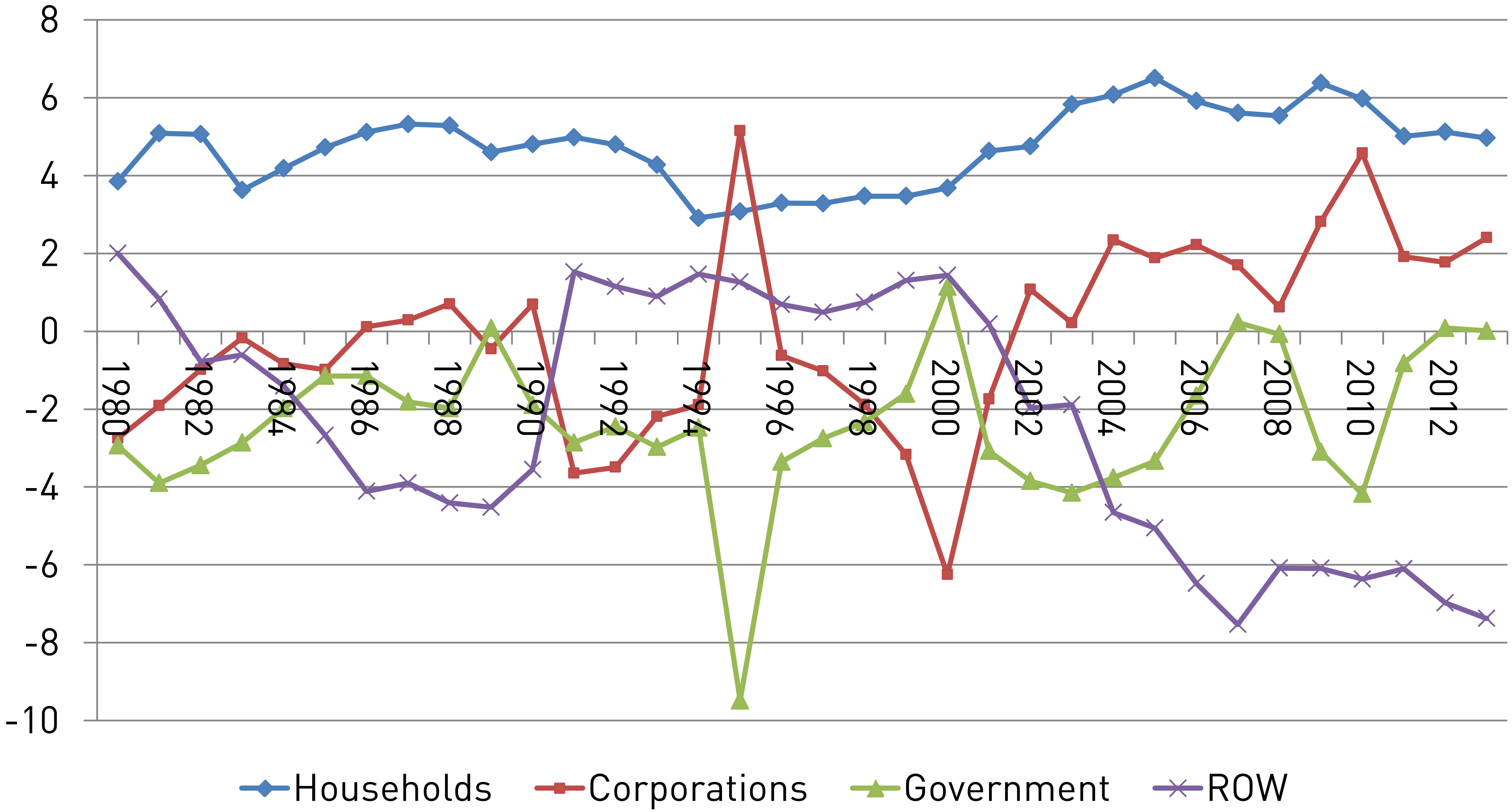
Financial Balances



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Germany as an export led mercantilist economy since the 1990s

- Germany as an "export led mercantilist economy"
  - Current account surpluses
    - Low wage growth
    - Low inflation
    - Weak domestic demand and low domestic growth contributions
  - Positive financial balances of the domestic sector / negative financial balances of the external sector
  - Different reasons for this type of regime, e.g. increased uncertainty through deregulation of labour markets, high real interest rates, **financialisation**…

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THE EFFECTS OF FINANCIALISATION

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1. Financialisation and inequality

- Period of financialisation characterized by remarkable increase in inequality
  - Labour share of income decreased (1980s 67,1% → 2008 63,3%)
  - Gini coefficient increased (market incomes 0,44 → 0,5; after taxes and transfers 0,25 – 0,3)
  - Strong increase of top 10% income share since mid 1980s (31% → 37%)
- Channels of influence (see Hein 2013 for a detailed analysis) on distribution:
  - Decline in government activity
  - Higher top management salaries
  - Higher profit claims of rentiers
  - Weakening of trade union power

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2. Financialisation and investment in capital stock

- Financialisation characterised by
  - Increasing shareholder power over management and workers
  - Increasing return demands by rentiers
  - Alignment of management interest with shareholder preferences via payment schemes

- Evidence for two effects on investment:
  - Preference channel
    - leads to short-termism of NFCs, decreased animal spirit and a preference for short term financial investment over long term real investment
  - Internal means of finance channel
    - extraction of internal means of finance constrains real investment activity

→ Financialisation has contributed to weak investment demand since the 1990s

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3. Financialisation and consumption

- Saving rates increased since the early 2000s in Germany (while crisis countries registered remarkable decline)
  - Redistribution in expense of labour income share and low income households (where saving rates are lower)
  - Increasing precautionary saving due to increased uncertainty
    - (low growth, high unemployment, deregulation of labour markets and reduction of social benefits)
  - Absence of wealth effects and "Keeping up with the Jonesens" phenomenon

→ **Financialisation has via different channels reduced consumption demand, ...**

...while the compensating effects, found in other countries (wealth effects and increased credit availability), have not taken effect in Germany

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THE EFFECTS ON THE CURRENT ACCOUNT

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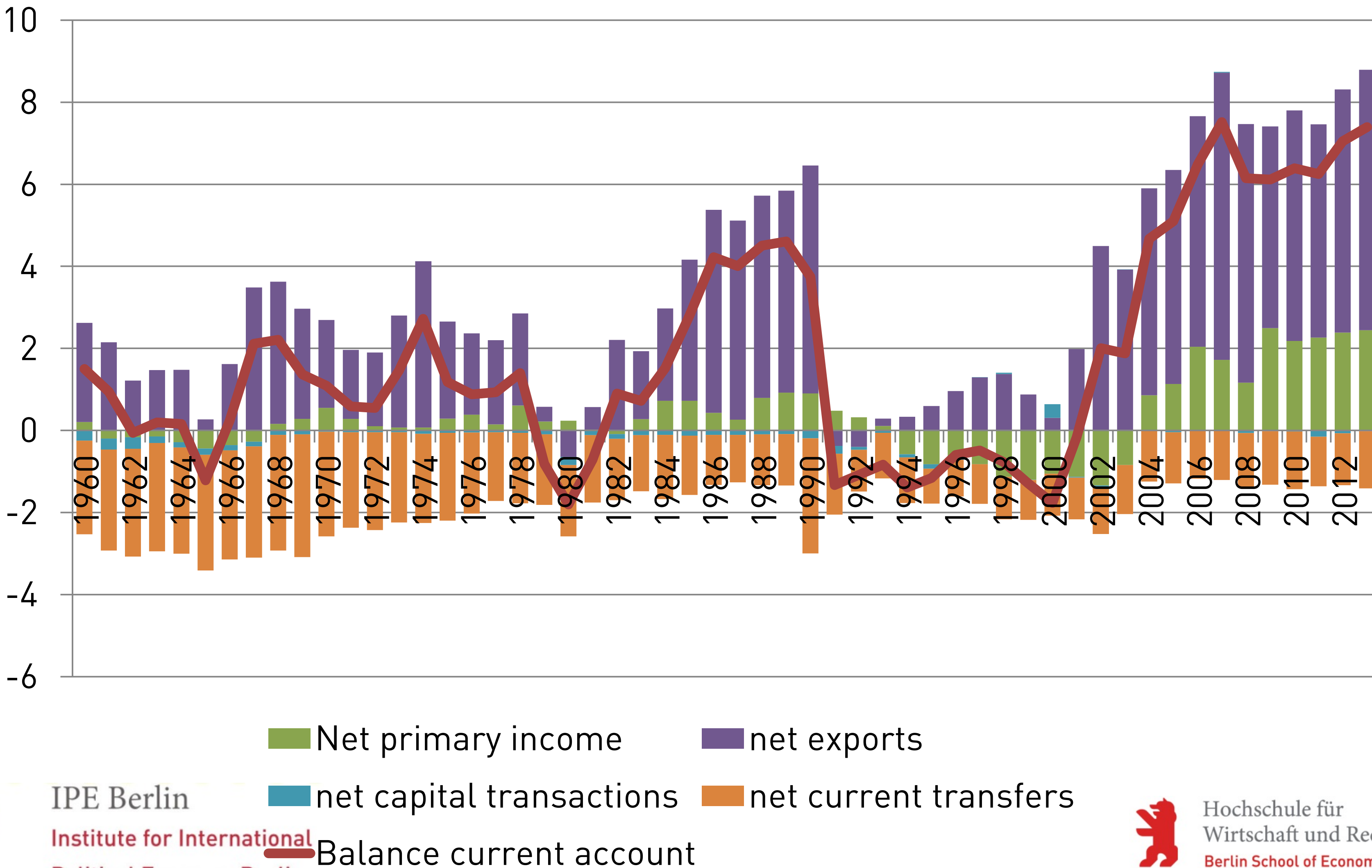
The effects on the current account



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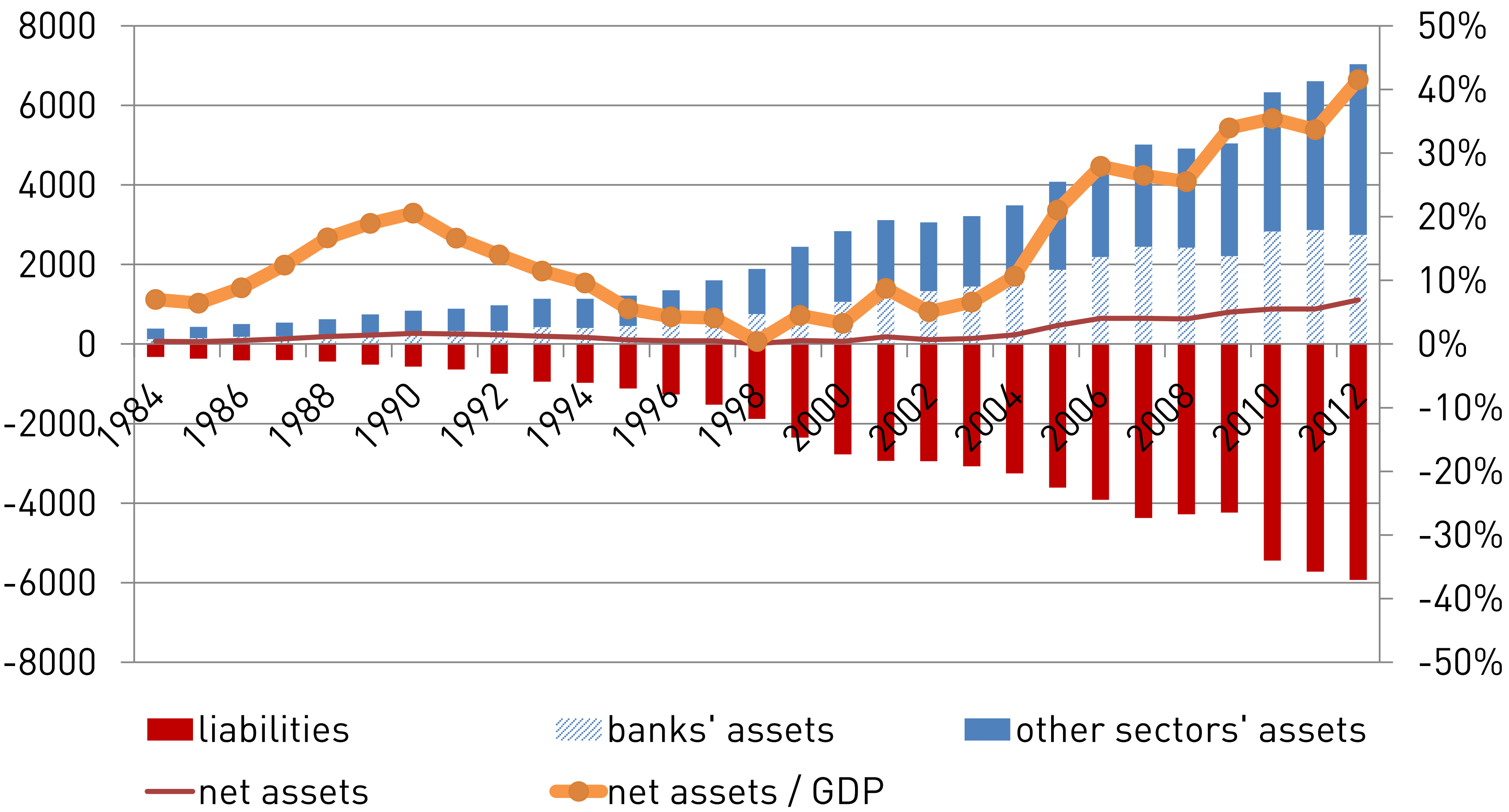

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The effects on the current account

- Three main phases
  - 1982 – 1992
    - robust growth based on domestic demand
    - AND high net exports and current account surpluses
  - 1992 – 2002
    - low growth with weak contributions of domestic and external demand
    - AND low net exports and current account deficits
  - 2003 – 2008
    - low growth with weak domestic demand AND
    - exploding net exports and current account surpluses

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The effects on the current account

- How to explain this differing experience?
  - Thirlwalls law:
    - Balance of payment constraint growth rate gives growth rate a country should grow at to have a balanced current account
      - Too low = current account surplus
      - Too high = current account deficit
    - Depends on
      - price competitivness (according to Thirlwall of minor importance),
      - non-price competitiveness,
      - external demand by trading partners

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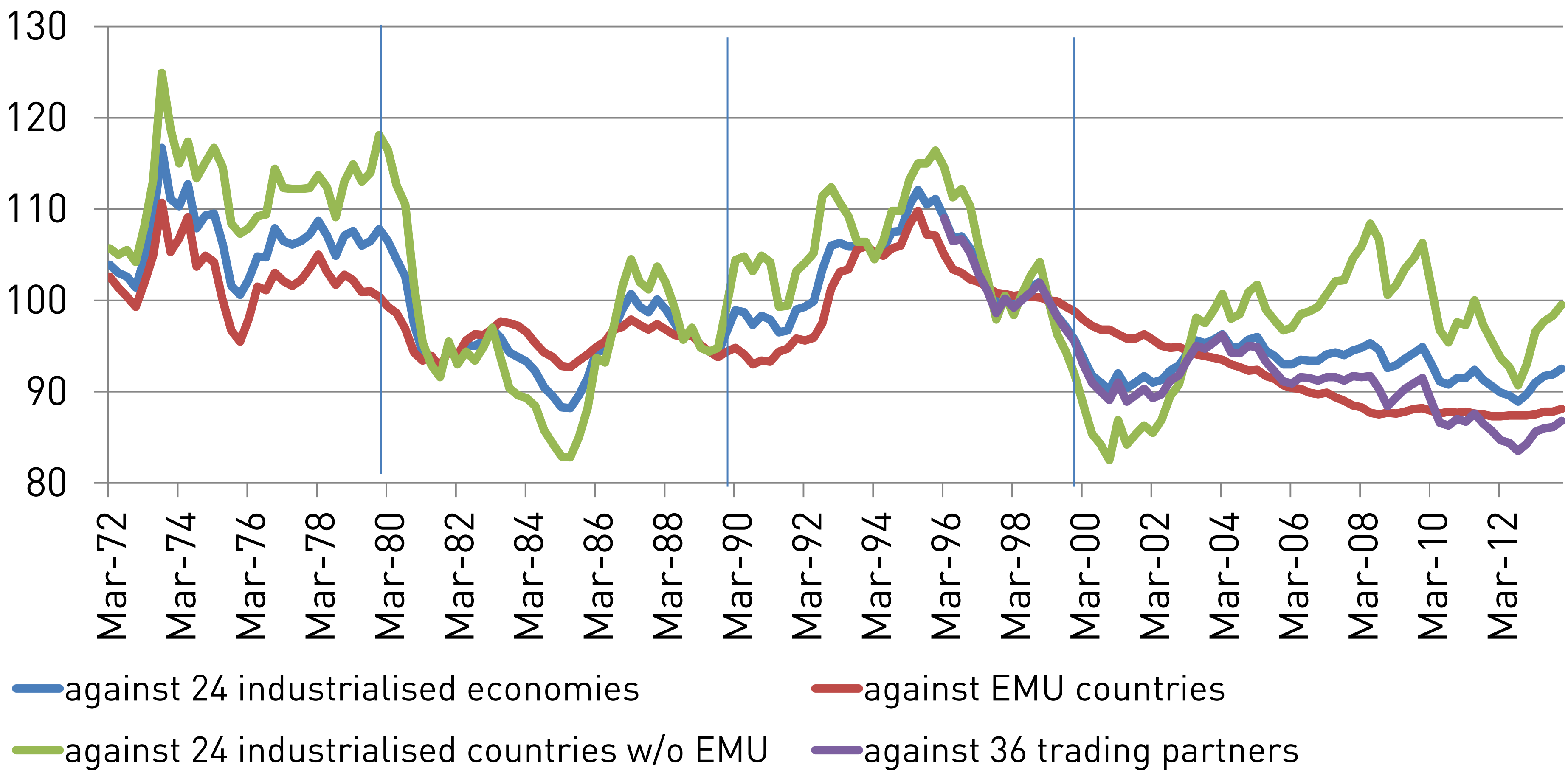
The effects on the current account – price competitiveness



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The effects on the current account – price competitiveness

- Net exports do not clearly correlate with price competitiveness
  - 1980s rather deteriorating competitiveness
  - 1990s first decreasing, then increasing competeveness
  - 2000s constant competitiveness
- Storm/Naastepad (2014) and Schröder (2011) only find very small effects of price competitiveness on the German trade balance in their estimations
- Thirlwall's conclusion that international price competitiveness is of minor importance seems to be confirmed

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The effects on the current account – non-price competitiveness

- Germany has a high non-price competitiveness in particular in the capital goods sector
  - Still high share of manufacturing in net value added
    - (24% in 2007, France 12%, UK 12%, US 13%)
  - Production in large industrial firms but also in the vibrant SME sector is focused on high quality R&D-intensive products
  - Ability to produce in this segment due to the German corporatist model, which still remains today (Storm and Naastepad 2014)

→ **BPCGR can be assumed to be relatively high as long as international demand for capital goods is high…**

→ **…and can in particular profit from growth in emerging markets with high rates of investment.**

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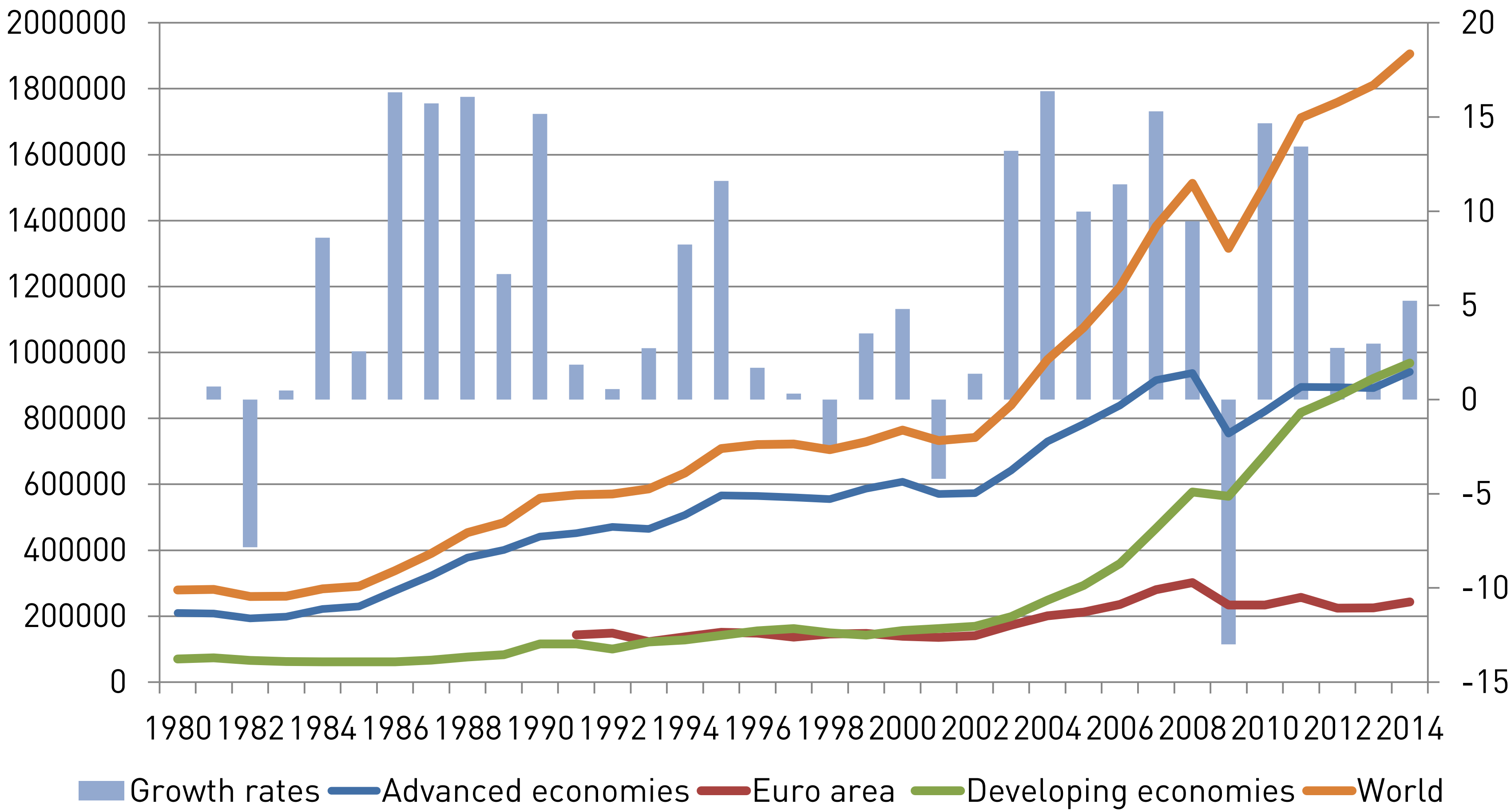
The effects on the current account – worldwide gross capital formation



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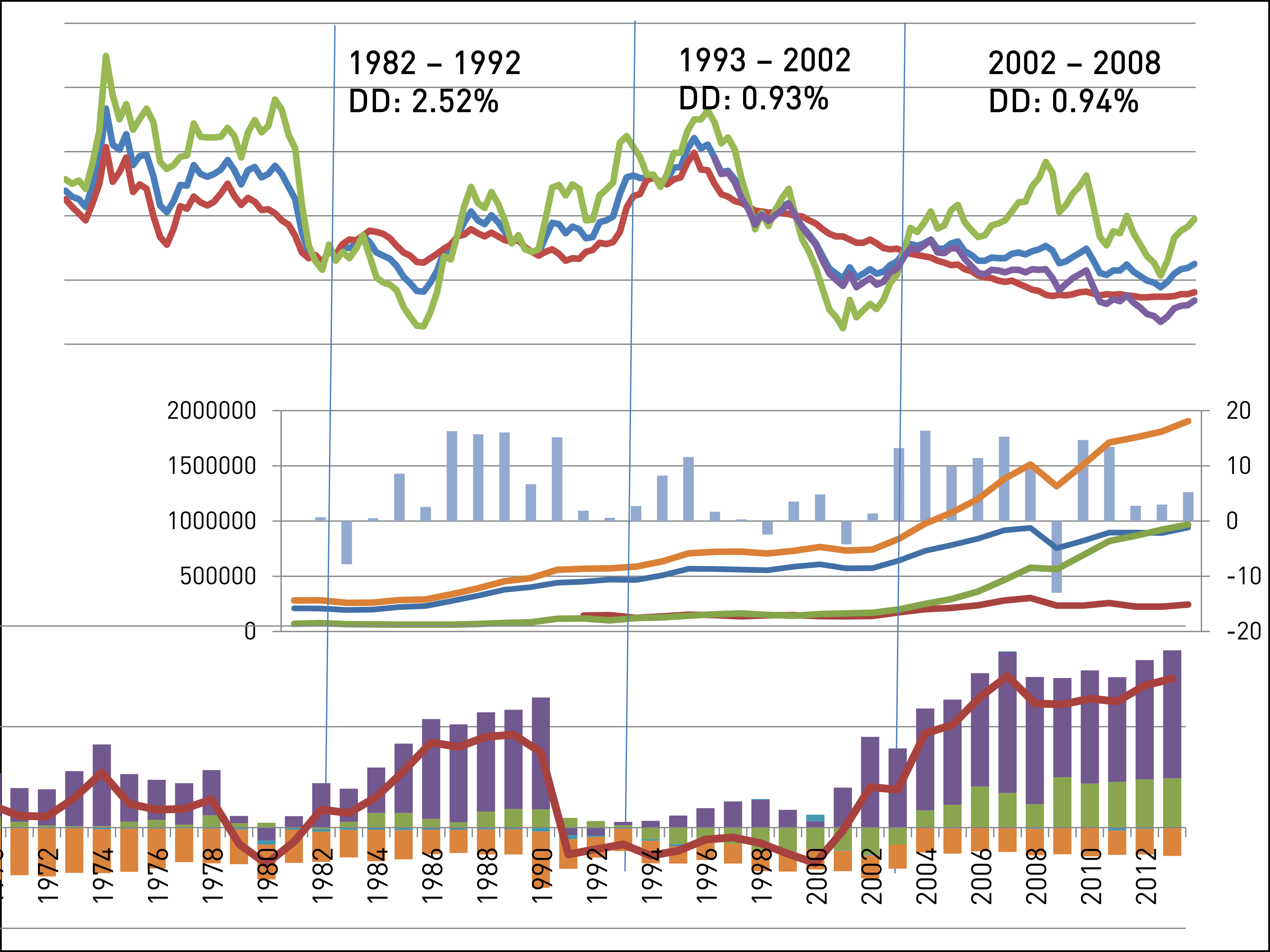
The effects on the current account – worldwide gross capital formation

- Germany's BoP constraint growth rate has a strong relation with worldwide growth in demand for capital goods
  - Average growth rates in
    - 1982 - 1992 7%,
    - 1993 - 2002 2.7%,
    - 2003 – 2008 12.6%
  - Storm/Naastepad (2014) and Schröder (2011) explain most of the variation in the German trade balance in their estimations by foreign demand



1982 – 1992
DD: 2.52%
1993 – 2002
DD: 0.93%
2002 – 2008
DD: 0.94%
2000000
1500000
1000000
500000
0
20
10
0
-10
-20
1972
1974
1976
1978
1980
1982
1984
1986
1988
1990
1992
1994
1996
1998
2000
2002
2004
2006
2008
2010
2012

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The effects on the current account

- Germany has a high non-price competitiveness in the capital goods sector
- Its BoP constraint growth rate depends largely on the development of external demand
- Price competitiveness is of minor importance

- Germany's weak performance in the 1990s
  - can be explained by depressed internal demand and ...
  - ...a low BoP constrained growth rate due to a stagnation in international investment activities
- The strong export performance in the 2000s
  - can be explained by an increase in the BoP constraint growth rate due to enormous international investment activity...
  - ...while domestic demand was still weak

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GERMANY IN THE FINANCIAL AND ECONOMIC CRISIS

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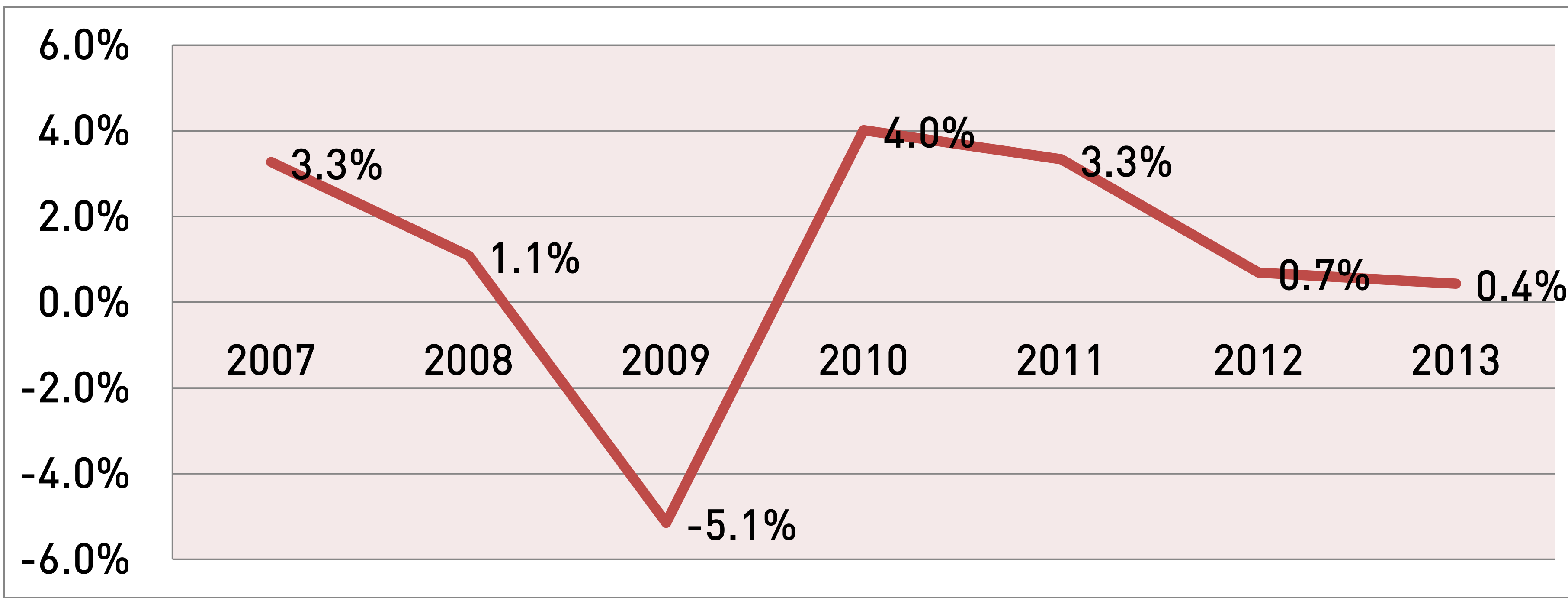
Germany in the financial and economic crisis

- Germany hit heavily by the crisis (GDP -5,1% in 2009...
- ...but extraordinary fast recovery (+ 4 / 3,3 % in 2010 and 2011)



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Germany in the financial and economic crisis

- Germany was affected by the crisis through two main channels
  - Financial market channel
    - – strong exposure to foreign financial assets (in particular by banks)
      - write-offs of major German financial institutions directly related to the crisis amount to 102 billion euros between 2007 and 2009 (total equity 700 billion euros).
      - major banking institutions get into trouble starting in July 2007
  - Trade channel
    - high share of exports in GDP, dependence on net exports for growth and specialisation in volatile sectors
      - growth contribution of exports -6.3 p.p., of net exports -3 p.p. (2009)

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Germany in the financial and economic crisis

- Why did Germany recover so well?
  - **Strong recovery rested on three pillars...**
  - Financial sector crisis could be contained
    - Due to enormous government support ((peaking at 323 billion in 2010)
    - and large part of the financial sector not affected so that no credit crunch occurred
  - Fiscal stimulus (stimulus package of 3.1% of GDP in 2009 and 2010) and good labour market conditions with no substantial rise in unemployment (supported by short time work) has stabilised domestic demand
  - Trade balance recovered fast since the investment boom in the developing countries did not stop with the crisis → Germany's exports shifted from the now depressed Eurozone to the emerging markets

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Germany in the financial and economic crisis

– … but suffers from two major drawbacks

- relies on the export-led neo-mercantilist type of development that considerably contributed to world and regional imbalances and to the severity of the crisis in Germany itself

- as a political precondition for the German stimulus packages, the so-called 'debt brake' was introduced and exported to the Euro Area
  ⇨ restricts severely the future use of fiscal policies

Conclusions

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- Financialisation took its effect in Germany in the 1990s
  - Has depressed internal investment and consumption demand
  - Positive effects on consumption like wealth effects and credit availability were not dominant in Germany
- External demand through the stagnation of international investment in the 1990s stayed low
  - Wage restraint as an answer to the weak performance deteriorated the situation
- When investment activity all over the world picked up net exports exploded, while internal demand remained stagnant
- Germany's recovery from the crisis was based on strong state intervention and the fact that the developing countries still have high demand for German exports
- … but rests on the previously followed fragile model and put a formal constraint on the future use of fiscal policy.

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...and some final remarks...

... on Germany as the poster child for the rest of the EA countries!

→Wage restraints were not the secret of success in Germany, but high non-price competitiveness based on regulated labour relations and state intervention

→Hence, wage increases in Germany largely can contribute to the reduction in Euro Area imbalances by stimulating domestic demand

→Germany's wage constraint in the 1990s and 2000s should not be taken as an example for solving problems in the EA periphery!

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Thank you for your attention

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