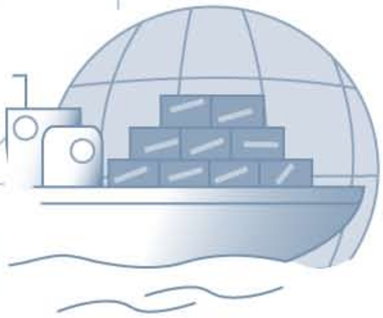
Compass 2020

Germany in international relations
Aims, instruments, prospects



Controlling the Risks of a Global Economy

Germany's Role

Michael Dauderstädt & Christian Kellermann

March 2007

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The Compass 2020 project represents the Friedrich-Ebert-Stiftung's contribution to a debate on Germany's aims, role and strategies in international relations. Compass 2020 will organise events and issue publications in the course of 2007, the year in which German foreign policy will be very much in the limelight due to the country's presidency of the EU Council and the G 8. Some 30 articles written for this project will provide an overview of the topics and regions that are most important for German foreign relations. All the articles will be structured in the same way. Firstly, they will provide information about the most significant developments, the toughest challenges and the key players in the respective political fields and regions. The second section will analyse the role played hitherto by German / European foreign policy, the strategies it pursues and the way in which it is perceived. In the next section, plausible alternative scenarios will be mapped out illustrating the potential development of a political field or region over the next 15 years. The closing section will formulate possible points of departure for German and European policy.

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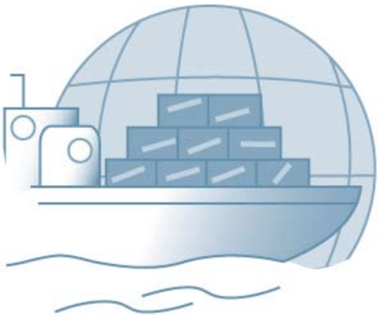

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Abstract

The integration of the German economy with the global economy contributes strongly to the economic dynamics and prosperity within Germany. As world export champion, Germany benefits from open global markets for goods, services, capital, enterprises and labor. At the same time, liberalization has weakened many national, governmental regulatory competences, except for those that have been transferred to the level of the European Union as part of the integration process. Germany's one-sided export orientation, as well as the increasing influence of international capital markets in the corporate and banking sectors, contain a number of risks for its own national economy, and also, in the worst-case scenario, for the stability of the global economy. The bottom line, however, is that Germany has benefited from globalization. Those problems that Germany's economy is currently experiencing (limited growth, unemployment, rising inequality) may be attributed to a complex interaction between foreign economic developments and national economic policies, and cannot be resolved by reducing Germany's integration in the world economy.

During the next decade, the essential risks in the global economy will mostly consist of an uncontrolled collapse of the US dollar and weak global demand. In Europe and the rest of the world, purchasing power of the masses will be reduced, triggered by lagging wages and a tendency to save, both driven by the risk of under-regulated markets; we may also face an uncoupling of productivity and output. The approach of German foreign trade policy towards controlling these risks is a strengthening of the European Union as the regulating entity of the regional markets most significant to Germany, and the bundling of individual European votes for the creation of a rule-based, regulatory global governance. Germany, as a major voice in the EU and world economy, can help advance improved regulation of the global markets – especially capital markets and their players – and thus mitigate the loss of effectiveness of its national economic policy. In the long-term perspective, the support of a sustainable global trade regime and the entrenchment of global minimum social protection rights will be essential elements in German foreign economic policy.

I. The Globalization of Germany

Foreign economic relations have an increasing influence on whether or not, and how Germany achieves its goals, in particular, a level of prosperity, which satisfies current demands. Through its active participation in global policies on liberalization and integration, Germany has opened its markets to goods, services, capital, enterprises and labor, while waiving numerous national capacities to control these markets. On the other hand, many partner countries have taken similar steps, providing opportunities for Germany's economy on their own markets. This process has most advanced within the European Union, and particularly in the Euro zone. Germany's role in the global economy essentially depends on the developments in other countries and regions, and is thus exposed to a series of risks. However, the bottom line is that Germany's economy has benefited from this development. Inasmuch as Germany's economy is currently experiencing problems (weak economic growth, unemployment, increasing inequality), these may be attributed to a complex interaction of foreign economic developments and national economic policies and cannot be resolved by reducing Germany's integration in the world economy. Even though a better regulation of global markets might very well contribute to alleviate the loss of effectiveness of its national economic policy.

I.1 Multi-Level Policy of Global Regulation

Germany has transferred major politico-economic competencies to supra-national institutions and international regulatory authorities. Consequently, its real economic integration has massively increased, which -- in connection with inappropriate national responses - has resulted in some problematic integration effects. Germany's ability to control production factors and the flow of goods crossing its borders, or even to regulate global markets, has been rather diminished. With the extensive globalization of the German economy, the level of policy making in general, and German foreign economic policy in particular, has shifted. For the most part that means it has been internationalized. On one hand, a number of formerly national responsibilities have been transferred to the international level. On the other hand, there are numerous international actors, such as international organizations and global players, all acting within the conflict-ridden arena of globalization. In this constellation of actors, there are regular occurrences of tension and disagreements regarding the degree of economic liberalization versus market regulation. The following section briefly analyses the various levels and actors within the global economy.

The regulation of Germany's foreign trade relations is meanwhile mostly subject to the European Union (EU), in which Germany may play a major role, but in the end has no veto right – here, in the `first pillar´ of the interior market especially. The competencies of the European Union concerning economic policy extend to customs duties and trade policy, single market policy, and to monetary and currency policy.

Transfer of competencies is even further advanced within the Economic and Monetary Union (following the Maastricht Treaty of 1992). In 1999 the European Central Bank (ECB) as the new, supra-national actor determines the common monetary policy of the Euro zone and decides on the interest rate for the entire currency area. The ECB also monitors the exchange rate of the Euro and is thus an important actor in international finance. On the fiscal side, the Stability and Growth Pact (SGP), as the link between the EU - and national levels, specifies limits to budget deficits and overall debt.

Multi-national corporations (MNCs) are the driving forces behind the liberalization of global trade in goods and services. Most of the MNCs are based in the US, Japan or

Europe. Increasingly, they have become actors in international policy, as they are able to play locations (nations) against each other by simply threatening to relocate their production facilities. `Market states´ ("Wettbewerbsstaaten") try to attract investors with competitive tax systems, legal standards, or direct subsidies. By virtue of the MNCs' being active in several legal systems, intervention and regulation by individual states is only possible on a limited basis. Instead, regulation, monitoring and taxation of MNCs demand international cooperation and global regulation, for instance, concerning the enforcement of certain environmental and social standards. Most of the regulation for MNCs today consists of codes of behavior and is primarily of voluntary nature and cannot be legally enforced.

The influence of large market actors is mostly of a structural nature. This is true especially in the finance sector, due to the specific creditor/debtor relations (via the capital market), and contrasts with regulatory concepts of many individual states. Powerful lobbying associations exert a kind of disciplinary effect on the agenda of the Bretton Woods Institutions, and especially on developing countries, for which access to the international capital market is a crucial factor for development and industrialization. But even as individual actors, large institutional investors (investment banks, insurance companies, fund managers, hedge funds) are in a position to use the sheer size of their funds and/or credit leverages to plunge both developing and industrial nations (e.g. Great Britain in 1992 or the US in 1999) into a financial crisis, necessitating concerted, multilateral counteraction as a reaction.

The central political actors in global economics are the governments of the major industrial nations (G8). The single most important actor in the world economy is the US government, whose unique status is institutionally set, as, for example, in the quota system of the Bretton Woods organizations, and through which the US alone has a veto right in the central decisions of these organizations. The global monetary function of the US dollar is the critical instrument in the US status, providing the US with a `seignorage´ advantage[1], permitting the internationalization of its own macro-economic preferences, and allowing it to dominate international finance and trade structure. The influence of the US in determining the rules of the game on the global markets continues to exist, despite many voices to the contrary, providing little hope for any multilateral regulation of the global money markets, in deviation from the liberal credo.

Following the example of the G8, additional "G fora" have been established: In 1999, a group of `systemically significant´ developing - and emerging countries as well as industrial nations formed the G20. Among others, the G20 include China and India. This forum represents two thirds of the world population, 80 percent of world trade, and 90 percent of the gross national product worldwide. In the financial sector, there is the Intergovernmental Group of 24 for International Monetary Affairs and Development, G24, abbreviated: It is a group of developing - and emerging countries in the IMF, representing common interests in monetary, financial and development issues in the Bretton Woods Institutions and other fora. Both of these fora play significant roles in the global economy, although neither the G20 nor the G24 present any significant counterweight to the G8 dominance. They still primarily serve the generalization and legitimizing of the economic policy goals agreed upon in the G8. However, emancipatory tendencies are becoming clearly evident.

There are a number of international organizations performing as actors in the global economy. Noteworthy in particular are the World Trade Organization (WTO), the International

[1] The seignorage advantage describes the specific function of the leading currency: The issuer of the world's reserve currency may pay its obligations abroad in its own currency. Thus, the issuer of the global currency benefits from the unique seignorage advantage - tempting certain abuse – of being able to force foreign holders of the key currency to finance their domestic budget deficit.

Monetary Fund (IMF), the World Bank Group (IBRD / World Bank), the Organization for Economic Cooperation and Development (OECD), and many more.[2] With the (preliminary) failure of the Doha Development Round of the WTO, multilateralism in trade issues is also exposed to rising pressure.

In the financial sector, the International Monetary Fund in particular is struggling for its function as a lender of last resort for developing - and emerging countries. However, it suffered a major loss of credibility at the beginning of this decade through its extensive resistance to reform and was increasingly perceived as a unilaterally operating instrument of the US government and powerful market actors. This led to skepticism and counter-reactions, especially in the Asian region, but also in Latin America, and in the end caused a crisis in the international finance diplomacy. Through the Chiang-Mai Initiative (the bundling of monetary reserves in Asia) and the early repayment of outstanding loans by Latin American countries, emerging economies became increasingly independent of the IMF and accelerated a tendency towards regionalization. In addition, with China and India, but also other large emerging economies (such as Brazil), new players emerge who demand a corresponding voice in the international organizations as well. The concessions of the industrial nations to date, however, have been rather marginal – at the Singapore Meeting of the Bretton Woods Institutions in September 2006, only China, South Korea, Mexico and Turkey were awarded a small increase of their quotas. Germany's representatives supported the increase and demanded additional reform steps such as the simplification and adjustment of the quota assessment in the Bretton Woods Institutions.

Non-governmental organizations (NGOs; also referred to as non-profit organizations), which are critical of globalization, criticize many policies of the international organizations (catch word: Washington Consensus). And they also criticize the limited progress in advancing the voting rights of developing and emerging countries within these organizations. As a basic principle, they support a much more comprehensive legally binding regulation international economic relations. For this, universally and democratically legitimized multilateral fora are needed, which also admit NGOs. It is largely thanks to modern communication technology, that NGOs have become instrumental in providing impetus in international economic relations. However, their influence is limited due to the insufficiency of their resources and access to state fora and public organizations. Their strategic weaknesses are partially due to the internal rivalry between reform-oriented actors and more fundamental opponents of globalization. The strength of the entire movement lies is in its ability to mobilize major protest actions, as those seen prior to the most recent WTO, G8 and IMF/ World Bank conferences.

Following the development of a global financial market and its growing importance in the financing of states and enterprises, the balance of power between the various actors has shifted on the side of major institutional investors and MNCs, which frequently act as bank-like institutions themselves. Individual governments increasingly run the risk of their countries acting as competitors for large investors, subordinate to a supply-side catalog of policy demands. Tendencies towards regionalization are becoming more and more evident, on the one hand cushioning competitive pressure (as in the EU), on the other hand, decreasing the dependency on the international organizations (e.g. through the Chiang-Mai Initiative). The observed informalization (`G-zation´) of international economic diplomacy and the marginalizing of international economic and financial organizations add to the difficulties. The consequence is an increased tendency towards non-cooperation, which may have negative consequences, especially for Germany with its

[2] International Organization of Securities Commissions (IOSCO), International Association of Insurance Supervisors (IAIS), Bank for International Settlements (BIS), Basel Committee on Banking Supervision (BCBS), Committee on the Global Financial System (CGFS), Committee on Payment and Settlement Systems (CPSS), Financial Stability Forum (FSF) etc.

comprehensive integration in world economy. The German (regulatory/institutionalist) approach has always consisted of a strengthening of multilateral systems and international organizations, with the goal of assessing, processing, and distributing relevant information. It has also been a "German way" to allow for stable expectations on the part of individual actors, and a rule-based resolution of conflicts. Neither the WTO (which has a formal arbitration mechanism for dispute resolutions), nor the international financial institutions have made fundamental progress in settling conflicts of interest or establishing global regulatory measures. Institutional surrogates and parallel fora, such as the Financial Stability Forum, may be instrumental in formulating standards, codes, and other behavioral rules, but cannot substitute for internationally binding rules such in the shape of an IMF article or WTO agreement. In global trade, this has already manifested in a creeping undermining of the principles of open markets and non-discrimination.

Germany's options for exerting a direct influence on these issues are limited to its participation in the G fora and the international organizations in which the government (typically the finance minister and/or the president of the federal bank) is represented – primarily the Bretton-Woods Institutions. Otherwise, Germany's influence is channeled through its work within the EU.

Against this background of shifts within the balance of power in international economic diplomacy, the following section outlines the integration process of the German economy in the world market to date, and its impact on German economic policy. We are primarily concerned with qualifying the German globalization process, thereby providing the basis for the later analysis of scenarios, specifically: What are the strengths compared to the vulnerabilities? We assume that many weaknesses in the German economy are homemade and only indirectly linked to globalization.

I.2 Global Economic Integration

Since 1952 Germany has had a trade surplus, which it uses to finance regular deficits in services (primarily tourism) and net payments to foreign entities (including development aid, contributions to the EU and other international organizations). The remaining (frequently still positive) balance then leads to an increase (or, if the balance is negative, a decrease) of Germany's net foreign asset position. Germany has the highest export of goods worldwide and one of the highest foreign trade surpluses worldwide.

The majority of German foreign trade consists of manufactured goods (app. 60 percent of imports and app. 75 percent of exports). The energy imports (oil and natural gas) so fervently discussed in recent years amounted to only 6.8 percent of all imports in 2004, and commodities to slightly more than 8 percent. However, the percentage of commodities has clearly increased since 1999, when it was still app. 5 percent. In the long run, the share of manufactured products may diminish if services continue to gain importance in international trade, as they already have within the domestic economy. Continuously rising prices of raw materials may increase their value share in the short term, but have a long-term tendency to decrease their volume share of imports, and thus their value share, too.

Germany's main trading partners are therefore the other rich industrial countries. In 2004, German imports from China were still below those from Great Britain, but China has grown increasingly important in recent years. Since 1998 it has almost tripled its exports to Germany, while the total of German imports has only risen by app. 36 percent. On the other hand, German exports to China are increasing at an even faster rate. As a result of the transformation of post-communist economies and the EU's eastward expansion, trade with central and eastern Europe has also increased. Its share of German imports rose from below 3 percent in 1990 to almost 10 percent in 2003, but this dramatic growth has probably reached its zenith. Germany was the beneficiary of the world trade's tendency towards regionalization here, the further progress of which, however, is likely to take place in regional markets less accessible to Germany.

Capital market integration between Germany and foreign countries has also increased. German financial institutions, corporations and households have invested abroad, and, in return, foreign investors have acquired assets in Germany. In this process Germany is basically a creditor nation, whose assets abroad exceed its liabilities, if only by 6 percent of the gross national product, whereby German private assets are counterbalanced by public debts owed to foreign creditors. Investments by foreigners in Germany are for the most part financial investments, which as such have no direct influence on growth and employment, but initially only change control of the enterprises involved. In the long run, however, such changes in corporate control, especially in the rather rare case of a majority participation, may lead to a new corporate strategy, which then may have an effect on growth and employment.[3]

German foreign direct investments are also quite rarely `Greenfield´ investments, which create new production and employment in foreign countries. It's even more difficult and rare to identify true production relocations, where stages of production and the jobs associated with them are clearly transferred from Germany to a foreign country. This does not, however, preclude the rise of German corporate activities abroad. Foreign investments are often only a part of forming cross-national production networks and value-added chains, which themselves are responsible for an increasing portion of the international trade.

Aside from the markets for goods, services and capital, Germany is also involved in the – albeit significantly less integrated and liberated – international labor market. In the past (1955 – 1975), Germany had recruited "guest workers" from foreign countries to a very large extent. Thereafter, immigration primarily took place for different reasons (resettlement from Eastern Europe, refugees, family reunions, etc.), although highly qualified foreign workers were still occasionally sought. Inside the European Union, the Free Movement of Workers prevails, which should extend to the new eastern European member states by 2010. Beyond that, some observers hope that the increase in immigration might mitigate of the, in their view, demographically-driven problems within the German economy.

I.3 Homemade Failures in Dealing with Globalization

Germany is suffering from a general tendency towards weak growth, combined with persistent, massive unemployment and increasing inequality. In light of the vast success in export and, simultaneously, the better labor-market and social performances of other rich welfare states, it is only natural to assess the German problems as less a direct effect of financial and economic globalization and more as the result of homemade errors in policy. In particular, Germany was unable to transform its gains from specialization – through the altered, international division of labor - into growth and employment.

To do so, it would have been primarily necessary to offer the redundant workers from

[3] This trend should be assessed quite critically: With the divestiture of the so-called `Deutschland AG´ [Germany Inc.] (divestiture of financial and industrial capital), the increasing significance of the shareholder value of a company is accompanied by a strategic realignment of the corporate governance in corporate groups and banks. A corresponding one-sided emphasis on above-average-profitable corporate sectors has negative employment implications, at least in the short - to medium range, and undermines corporate tradition. In order to speak of a long-term trend in this context, the capital market would have to assume a central role in financing corporations, and company shares would have to be held by strategic, institutional investors – a trend we are currently observing. In this regard, the interest of the financial market is increasingly focused on Germany.

the declining sectors (typically industries – e.g. the textile industry – and production processes which, exposed to international competition, use lots of low-skilled labor) new employment. This would have increased output and income. Instead, redundant work forces were often dismissed to long-term unemployment or early retirement, having to be financed through a re-allocation of funds from stable or expanding industries. The necessary expansion in domestic labor demand failed, due to economic conditions on the European level, which are unfavorable to Germany. Both the Maastricht criteria and the monetary policies of the ECB slowed down German economic growth through high real interest rates and restrictive fiscal policy, thereby increasing the pressure on business to push exports and cut labor costs.

What effects do the energy -, i.e. oil shock, the rise of China and India, the oversupply of manufactured goods, especially from low-wage countries, and the excessive demand for raw materials produce? They obviously have not led to a deficit in the current account balance, but they have worsened the terms of trade. The growing import of labor-intensive finished - and semi-finished products will continue to put a strain on the job market, but also provide opportunities for increasing prosperity. The Sinn theory of a `Bazaar Economy´ is not only empirically doubtful, but also problematic in a theoretical and political sense, since its consistent application would require a radical strategy of import substitution.

What implications for foreign economic relations does Germany's other major socio-political challenge, its demographic development, have? In principle one might assume that in future the then older German population will consume more than it produces. If this does not take place because a socially oriented, highly productive and active population is willing to finance the older citizens' consumption, no new foreign economic challenges would result. If it does, however, imports would increase, and a deficit in the trade balance may be expected, which would be easier to finance, if Germany had previously developed strong, positive net foreign asset positions. However, such long-term investments are subject to significant risks, in particular since the ideal, demographically speaking, target countries with high population growth are mostly unstable.

Whether or not immigration can solve such problems is also questionable. It would have to consist of well-qualified people, of whom there is an insufficient supply worldwide, since countries with a comparable educational level possess similar demographic profiles, and since Germany competes with many similarly structured nations for this limited supply of potential immigrants with suitable qualifications. As long as simultaneously less qualified German workers remain unemployed, domestic tension is inevitable.

II. Strategies of German Foreign Economic Policy

As described in the opening section, many of former Germany's economic policy competencies are now located in Brussels and Frankfurt. However, the formation, distribution and enforcement of German policy positions are primarily conducted by the Federal Ministry of Finance, the Federal Ministry of Economic Affairs and Technology, The Central Bank (Bundesbank), the Federal Ministry of Economic Co-operation and Development, and the Federal Foreign Office. Some of the individual policy proposals are heavily contested between the individual departments. German foreign trade policy is further characterized by a close cooperation with partner countries featuring a similar regulatory bias, and also by the integration of globally linked, moderate NGOs, domestically and on an international level.

German foreign economic policy to date has consisted of a liberally oriented, multilateral approach through which key preferences, such as the independence and monetarist approach of the European Central Bank, were internationalized. Germany's long-term strategy, on which the approach is based, is the mercantilistically inspired advancement of its export business. Thus the strategy of a strong currency serves to force exporters to engage in price discipline and quality improvements. From this perspective, there is no contradiction between export and hard currency orientation. The reverse side of this strategy is domestic economic self-discipline. Devaluation together with a boost in domestic demand would create the danger of additional inflationary pressures.

The multilateral approach of implementing a stronger regulatory regime is especially noticeable in trade policy (responsibility of the EU) and in the German financial diplomacy of recent years (relatively independent of the respective governmental constellation). Based on an institutionalist understanding of the economy, an attempt was made in the financial sector to correct market distortions and information asymmetries through binding global regulation. The German position on this issue has usually differed from that of the US administration. The virtual preponderance of the US in international financial institutions and their influence – often aligned to interests of its domestic finance business – not only intensify systemic dysfunctions of international financial markets, but also cast doubt on the Bretton Woods organizations and the multilateral system as a global *Leitmotiv*. Germany's approach of the last 10 years for a stronger independence of the international financial institutions is definitely the move in the right direction. The corresponding measures proposed such as an increase of internationally legal regulation, and a restriction of the discretionary influence of powerful governments match this goal. As an individual country, however, Germany is relatively powerless to transpose more fundamental changes in the international finance architecture. As in the field of exchange rate policy, this demands the participation of the EU, in this case, via Brussels. A common foreign economic policy with the EU performing as a single actor would represent a serious institutional counterweight to the US, even though no essential changes within the finance system can be enforced against the institutionalized veto rights of the US.

German initiatives, like for example the pressure to set up the Financial Stability Forum, have been a result of the institutional dominance of the US in the established organizations. However, in the end their influence is relatively minor, since those types of fora are not binding to the actors (neither market actors nor governments), and the standards and codes created therein regarding issues of transparency may even have the counterproductive effect of stymieing more extensive and binding demands.

Germany's policy approach further consisted in the support of debt relief for heavily indebted poor countries (HIPC Initiative) and the Millennium Development Goals of the United Nations. In the Doha Round, Germany (or better: the EU) also demonstrated a willingness to compromise on lowering agricultural duties, thus taking an important step in the direction of developing and emerging economies. The Doha Round initially failed because of the US refusal to offer more extensive reductions in subsidies. With regard to the new powerful actors in the global economy, the strategy of involving large emerging economies into the `Industrial Nations Club´ presents a guiding principle of the German government.

Based on the above-mentioned trends in Germany's role within the global economy (referring to both the constellation of actors as well as its industrial profile) the following section will develop the two scenarios announced in the introduction. In both scenarios, perspective focuses on the period until year 2020, with the aim of briefly outlining the two most probable directions the global economy is likely to take over the next 15 years. Thereafter, a draft for respective options in German foreign trade policy is developed.

III. Two Scenarios Extending to the Year 2020: Triggers, Costs, and Risks

The future development of the global economy depends on a variety of factors, which are difficult to assess. The following scenarios do not take into account major changes, including, i.e., natural disasters, cross-regional wars, crises in political systems of important nations like China, technological revolutions like highly efficient solar energy technology, or any other massive shocks, such as acts of terrorism. Some hard-to-assess factors, however, will be addressed below. The two scenarios presented here describe only two rough development trends, in which the decisive factor is the occurrence (or non-occurrence) of a collapse of the US Dollar.

- The continuation of previous trends – unless their discontinuation is foreseeable – serves as the reference scenario.

- The second scenario projects a world economic crisis, driving the zero-sum aspects in the global economy and urging all countries to adopt more egoistic policies, which contribute little towards overcoming the crisis.

We will do without a third scenario, optimal from a German point of view (realization of the Lisbon goals of the EU with a strongly growing, fully employed Germany and Europe and concurrent `normal´ development in the remaining regions), as there are few indications for it at this time.

III.1 Reference Scenario: Continuity of Unequal Growth

This scenario presumes that basic growth trends in the most important world regions, i.e. countries, will not change dramatically (in other words, except for minor fluctuations in the economic cycle). This means:

- China and India continue to grow at 7 to 10 percent annually, since they are still far from the productivity frontier. Domestic growth orientation also continues to rise, partially due to a tendency towards currency revaluation, which will lower the trade surplus despite rising exports.

- The US grows at a slower pace than previously to reduce its trade and budget deficits, without the dollar's collapsing, albeit slightly losing in value. Higher inflation rates provide real relief to some of the indebted sectors of the US economy (government, households), but growth is reduced, in part because of higher interest rates (due to an anti-inflationary policy of the US Federal Reserve Bank).

- Latin America and the remainder of Asia and Africa continue to grow at the same rate, around 2 to 7 percent, due to these regions' inability to create the social and political conditions needed for rapid growth.

- The EU experiences only marginal adjustments but no massive crises (no withdrawal from the Euro zone), at a growth rate of 2 to 3 percent. The Euro is revaluated slightly upward, keeping inflation low, so that the ECB does not have to drastically raise the interest rate. This will facilitate the adjustment process of debt-driven boom countries (Spain, UK), and permit a stronger growth in the core member states.

The commodities market continues to be characterized by strong demand, which causes slow, yet real price increases. This, however, will lead to shifts in consumption and access to new supply sources. Demand on the part of commodity-exporting countries will increase. Energy prices remain high but no longer rise dramatically, since refinery capacity and marginal suppliers (e.g., of oil shale and bio fuels) will increase.

The markets for manufactured products remain under pressure from Chinese exports, although the price pressure somewhat decreases. At the same time, China's purchasing power and demand – as that of other emerging markets and commodity exporters – for investment goods and high-quality consumer goods increase, providing Germany with additional market opportunities. Due to the continuous, global division of labor and the additional offshoring of labor-intensive production to the Asian region, the process of the de-industrialization of Germany is expected to continue. The pressure toward modernizing the production structure (training system, research, and innovation) and toward the expansion of the service sector remains. The low-skilled work force made redundant by manufacturing industries, require job offers primarily in the domestic-market-oriented service sector, which suit these workers' qualifications. The adjustment process is to some degree painful. Nonetheless, the rise of China, India and other poor countries may also contribute to Germany's prosperity – if the adjustment process is intelligently steered and successful.

III.2 Crisis Scenario: Dollar Crash and Weak Global Demand

This scenario assumes that the adjustment processes needed to lessen the impact of existing imbalances do not take place in form of a soft, smooth landing but instead of a series of shocks triggering additional imbalances and reciprocally exacerbating each other to a point of crisis, at least for some time. The trigger may – or may not – be a collapse of the US dollar, if international investors are no longer willing to participate in financing the American twin deficit (budget and trade) to the previous extent. Such a reverse in investor attitude might also be the result of the partly politically, partly economically motivated decisions by the dollar hoarders to date, China and OPEC, to get out of the dollar. A severe collapse of the dollar would significantly dampen the purchasing power of US importers (consumers as well as corporations), and could lead to a growth collapse in China, India, and the remaining world (including the EU, and especially in Germany). The collapse of stock markets, together with devaluations, additionally frighten international financial investors, who in the last few years had unrealistically high profit expectations, potentially triggering debt crises.

Globally weaker growth should relax the situation on the commodity markets. However, lower volumes and prices lead to a decreased purchasing power on the part of commodity exporters. The increasing competition for shrinking markets may lead to a battle for raw materials, as access to the cheapest sources takes on even more importance. At the same time, vehement export campaigns increase (due to lower domestic demand), supported by mercantilism and protectionism (competitive devaluation or disinflation). Trade policy conflicts reinforce the tendencies towards regionalization because, thanks to hegemonic powers, the regions still harbor the hope of being able to control overly damaging beggar-my-neighbor policies.

Costs and risks, especially in the crisis scenario, but also to some degree in the reference scenario, lie in unemployment remaining high and prosperity having to be partially sacrificed on the altar of competitiveness, potentially forcing Germany to participate in military action to secure raw materials, or at least believe that it must make foreign policy concessions to suppliers, such as Russia. The regionalization of the global economy could intensify, even though an appreciation of the Euro may pull more imports in the Euro zone, which would not compensate, however, for the loss in U.S. consumption due to a devalued dollar, and thus not prevent the global collapse of growth.

In Germany and in Europe a potentially strong influx of dollars would initially lead to the Euro's appreciation and rising prices of European/German assets (stocks, real estate, etc.). This asset price inflation does not necessarily mean inflation in goods markets, since cheaper imports would have a dampening effect. On one hand, the heavy influx of foreign capital might lead to a repeat performance of the \`Locust´ debate, and, on the other hand, bring about another wave of economic nationalism (fear of foreign takeovers). Rising asset values, however, would also strengthen consumer spending by providing an illusion of prosperity. The ECB would have to decide if it should put a halt to this asset inflation or, in view of low consumer price inflation, tolerate it. Attempts to arrest it by means of raised interest rates would have the fatal side effect of attracting additional capital.

In both the crisis – and the reference scenario, there are political options to, minimize costs and risks, and make use of opportunities. During a crisis, the most likely policies to find supporters are protectionist policies along the line of \`everybody for himself´, which generally escalate a crisis situation. In this case it would be necessary to counterbalance the emergence of the crisis scenario while still in the reference scenario, something rather difficult, given the existing hegemonic power structures with dominant free-market oriented actors.

IV. German Foreign Economic Policy Options

Germany's future prosperity depends on certain regulatory structures of the international economy remaining intact or developing in such a manner as to counterbalance currently existing imbalances, while primarily serving German interests. These interests, however, are not without contradictions – between consumers and producers, between capital and labor, etc. The relevant regulatory elements extend from the immediate surroundings of the European region and the EU, over its neighboring regions and the OECD countries, to the global economy.

German foreign trade policy has several channels of influence available for articulating its interests in trade - and finance matters (EU, G fora, international organizations). Especially in the reference scenario, there are a number of options for working against a continuation of the current development trends through a gradual evening-out of the large trade imbalances. This would require the establishment of a new, global, politico-economic consensus, which deviates from the basic alignment to a neo-liberal globalization and returns to the strategy of more closely embedding economic activities in a political body of rules and regulation. Germany's actual opportunities for exerting influence in this respect, as an individual actor, are limited. Its chances increase through a transfer of authority to the EU level. The veto rights of the US in the Bretton Woods Institutions – something that has prevented many reforms during the last decade and caused multilateralism to suffer a legitimacy crisis, counteract this, however. The formation of a new regime for politically structuring globalization and creating sustainable global trade regulation is therefore only feasible as a result of power shifts in the wake of the crisis scenario.

IV.1 Europeanization and Multilateral Regimes

The institution of Europe plays a dual role in the policy options: a) First, Europe offers the opportunity for creating a stable, regional economic block through the comprehensive coordination of individual economies, while relatively shielding the same from global economic shocks. b) Secondly, the bundling of individual European voices in the existing multilateral fora can reinforce European regulatory demands.

a) Shaping the European Economy

The Euro zone is the central policy arena, where the priority must be to secure the continuous expansion of supply and demand, together with a long-term balanced current account, through coordinated monetary, fiscal and wage policies. The current system demonstrates a one-sided bias towards stability, which has slowed down Germany's growth in recent years. On the reverse side, there is the threat of a collapse in demand from other Euro-zone members like Italy or Spain, should their economies enter a recession as a reaction to their – compared to Germany – higher unit labor costs. The EU needs a competition policy, which controls the race for real subsidies to business by continuously lowering taxation and subsidized wages. Germany should insist on reviving and promoting the macro-economic dialog. In light of the reference scenario, stronger growth in Europe would reduce the role of the US as the `global consumer of last resort´.

In addition, Germany (like all core EU member states) must be interested in a rapid growth - and modernization process in the neighboring regions. This demands some painful adjustments in Germany as well, but at the same time offers the best conditions for political and social stability, as well as growing sales opportunities for German exports. The catching-up process of the neighboring countries firstly requires a real development process, accompanied by the necessary investments and increase in productivity. To support it, Germany, and the EU, should not insist on their traditionally free-market, regulatory concepts, but tolerate promising, heterodox policies, such as those adopted by the Asian Tiger economies or China. Secondly, a nominal catching-up process in prices and income is needed, partially executed through the appreciation of currencies, and partially through slightly higher inflation. Both processes require a delicate balance, since excessively rapid, nominal catching-up processes reduce competitiveness, and excessively slow catching-up processes may give away the profits of economic prosperity and restrict the purchasing power of the neighboring countries – this also to Germany's disadvantage. The economic policies of the EU could contribute to stabilizing the balance by not punishing real appreciations through an exclusion from the Euro zone, and by providing monetary guarantees, rendering the accumulation of large, demand-reducing currency reserves to protect against financial crises, unnecessary.

b) Strengthening the European Voice in Global Economic Governance

The development of a common European political position and the presentation of the EU as a single actor in multilateral fora represent the fundamental pillars of Germany's future foreign economic policy, both in the reference – and the crisis scenario. The starting point, however, is not that of homogenous (regulatory) interests among the EU member states, but of conflicts of vested interests within and between the individual member states. A (German) regulatory policy, therefore, must primarily be aimed at strengthening heterodox social forces in the member states. In the end, Germany's unilateral options for exerting influence on the structure of the global economy in general, and the financial markets in particular, are mostly indirect. Options for a direct influence are the immediate restructuring of its own economic and industrial structure as well as its fiscal activities. If the crisis scenario occurred, a massive intervention by the European Central Bank (together with other major central banks, including China's) would be required.

Whatever competencies have already been transferred to the European level, in terms of economic issues, should also be established in the financial sector. Germany's foreign trade policies should be completely Europeanized, since the influence of individual nations in international organizations and fora of international economic and financial relations is being increasingly marginalized – not the least due to the legitimacy crisis of the organizations themselves. Theoretically, an active approach to Germany's role in the global economy consists of the cooperative collaboration in multilateral fora, with special emphasis on the inclusion of systemically relevant emerging countries, plus a coordination of positions between EU member states, especially of the Euro nations. Only by reestablishing the legitimacy of a binding multilateral framework together with rule-based institutions and organizations, will it be politically possible to even out systemic imbalances in a regulatory manner and preemptively counteract their development. Democratizing global governance in the sense of a balanced participation by all nations in the international organizations (e.g. according to their gross national product in purchasing power parities), an increase in transparency and accountability of the organizations, as well as a stronger participation of non-profit organizations, are the prerequisites for such an approach.

The largest obstacle in the creation of a sustainable global trade regime is the institutionalized veto status of the US government. Any successful global regulatory initiative by Germany or the EU would therefore most likely ensue as a consequence of our crisis scenario (a US default as crucial window of opportunity, resulting in a fundamental shift in the balance of power between foreign - and domestic actors). Broad coalitions between political and non-profit organizations, which might try to advance a reform model against the interests of the US, have been – and will continue to be – rather unsuccessful. In the reference scenario, only smaller `learning steps´ are realistic, which may not extend beyond the issues relatively neutral to special interests, such as an increase in transparency.

IV.2 Regulating Global Financial Markets

The programmatic target of Germany's and the EU's multilateralism must be the articulation and anchoring of a consensus on regulating global financial markets. Such a consensus would in general provide more room for macroeconomic steering and attempt to institutionally counteract the buildup of systemic risks, such as major exchange rate fluctuations and trade imbalances (surplus *and* deficits). Such a globally coordinating approach would require strong, democratically legitimized international organizations and regulations. The central (economic-) diplomatic starting point in forming such coalitions would be convincing large, emerging market countries in such fora as the G20 of the necessity of this approach. In recent past, it was these countries – albeit potentially the beneficiaries of a stabilizing global governance – that have been weary of integrating and coordinating their economic relations and activities to date, for fear of rising credit costs or restrictions in accessing (capital) markets. Due to this resistance over the last ten years, many valuable reform projects initiated and supported by the German government could not be realized.

A policy of an active global governance has to involve (capital) market actors in such a way that their (systemically rooted) pro-cyclical and – on an aggregate level – potentially crisis-prone behavior is counterbalanced by a convincing, sophisticated regulatory approach. Otherwise the international community would be forced to provide a public safety net for market failures, and bear a majority of the costs, thereby accelerating the inclination of investors to take dangerous risks (moral hazards). A general increase in transparency already constitutes a major step in the right direction. In addition, involving the private sector in crisis solutions and a fair burden-sharing between creditors and debtors is necessary – comparable to national insolvency procedures. The establishment of an international insolvency (or debt restructuring) mechanism for sovereign creditors would be an important contribution to the stabilization of the global financial architecture. A better surveillance of hedge funds, plus a greater acceptance of capital controls (in developing and emerging economies) would be equally useful measures to be taken. In case of a massive flight out of the US dollar, as outlined in our crisis scenario, all three measures – a debt restructuring mechanism, comprehensive surveillance of market actors, and use of capital controls – would represent essential mechanisms in crisis intervention. If these measures were implemented in a consistent, timely manner, they would also function preventively. Such measures in global monetary policy would have a sustained effect on the reduction of currency hoarding, such as in China and Japan, and promote a more productive management of reserves (e.g. using them to import capital goods from industrial nations).

IV.3 Sustainable Global Trade Regime

Closely related to the reference scenario is the question of a sustainable world trade regime with social standards and basic labor rights. Offensive beggar-my-neighbor policies induce global trade imbalances potentially leading to the above-mentioned crisis scenario. Any counteraction requires a more sophisticated and sequenced liberalization, symmetrically aligned and linked to minimum social standards. In the short-term perspective, it makes sense to revive the Doha Round, although pressure on developing countries to liberalize markets should not be too high. For years has world trade politics been fixated on the reduction or removal of trade barriers (duties, quotas, etc.) This removal, however, is primarily in the short-term interest of exporters and consumers in import nations. With flexible exchange rates, revaluation compensates for consistently high duties anyway, negating the price advantage of protected domestic production.

As in the European region, it is also true on a global scale that rich nations must be interested in a long-term increase of the purchasing power in import nations, which, in the end, also depends on these nations' export opportunities. If poor countries develop faster under a more protectionist regime than under conditions of a "big-bang" liberalization, the latter should not be enforced without specific need. This assumption is supported by the success in Asia as well as the positive record of the pre-globalization period (1945-1975). By opening their markets, rich and flexible economies contribute more to global growth than poor and encrusted economies. Instead, the asymmetric status quo forces such countries into niches related to their few, already existing comparative advantages (often "rent-seeking economies"). In this sense, a more pronounced long-term perspective should have priority in future trade rounds. At the same time and in the same context, pressure within the EU to reform its own agricultural policies should be increased.

The liberalization of trade and investments should continue to be negotiated under the umbrella of the WTO, and should be included in a stable, multilateral, regulatory system of non-discrimination. This applies particularly to the commodity markets, and to oil and natural gas especially. Germany should therefore counteract any efforts to further cartelize these markets and simultaneously develop and promote alternative sources of energy. As long as the market mechanism (instead of a political-military) functions in regard to global energy provision, supplying Germany and Europe, rich and strong in exports as they are, should not present a major problem.

In addition, the various fora should be expanded to include the civil society. The binding establishment of global, minimum social protection must be a central legal component of world trade. As described in our scenarios, aside from the protection of workers, social standards also contribute to economic development (as investment incentives), are instrumental in reducing the asymmetries in global development, and help avoid major imbalances caused by different development strategies.

The capitalist world economy is a mighty force in the creation of prosperity, but it has inherent weaknesses and dangerous tendencies, potentially leading to self-destruction (see crisis scenario above) in the absence of political and social control mechanisms. The three major blind spots concern the protection of workers, the environment, and the consumers. Neglect or exploitation in these three areas can yield short-term advantages in form of increased productivity, higher growth rates, and higher profits, in other words, stronger `competitiveness´ currently so highly valued. Any counteracting measures to protect the environment or labor forces are seen as placing a burden on enterprises by limiting their options in off-loading their costs to society (externalization). To avoid the neglect of long-term growth opportunities and protect the interests of employees, consumers, and those dependent on a sustainable environment, global races to the bottom should be halted. Germany’s role in the global economy in 2020 should be a progressive European, committed to embed market processes, and setting standards for social - and environmental protection. Such standards would be much more easily implemented in the reference scenario, when wealth generally increases, than in the crisis scenario, when zero-sum thinking subordinates all goals to the dictate of a misunderstood competitiveness. There is an asymmetric chance for reforms in global economic policy: While regulation of the capital markets is more likely to occur in times of crisis, the chances for trade and production standards are actually higher in the reference scenario.

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