European Reforms and the Leadership Deficits of Surplus Germany

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Excuse the incomplete citations

Abstract: This paper draws a connection between two major European challenges that are generally treated as separate problems, namely European economic imbalances in trade and capital flows and refugee flows. While both have important benefits for some actors, each is potentially highly disruptive as well. The paper puts 'Surplus Germany' at the analytical and political center of both problems, each of which has implications for the Central and East European (CEE) member states of the EU. We show that Germany has *externalized* its key economic problem—a persistent imbalance between surging domestic production and lagging consumption—to the rest of Europe and the world, while *internalizing* a key global problem—refugee flows—to the EU context. Indeed, we argue that CEE nationalism is itself partly a consequence of learning the hard lessons of becoming a counterpart to German capital flows, which Southern Europeans and, now, Americans have also found extremely disruptive. Meanwhile, Germany's refugee policy is also a huge challenge to CEE, as most states there are reluctant to harbor refugees. Aside from political and cultural anxieties, another part of this resistance to refugees arises from the highly-skewed returns to skills now evident in the CEE region and that result from dualist labor markets. The paper concludes with implications for reform proposals for the EU.

When we agreed this spring to write a paper about German attitudes to European reform proposals, there was a glimmer of hope that German positions vis-à-vis European reforms might turn in a more constructive direction after the fall elections. Those hopes—however modest—have now been dashed. And while the European economy is in better shape than it has been in years, we believe it still requires important reforms that are not likely to be forthcoming in the medium term. Instead, absent a return to grave state financing problems in the Eurozone, any major changes in the EU's architecture—at least, any that would require a treaty change—seem off the table for the moment.[1] Given this context, it seems more useful to reflect on how German policies—which still have the support of German voters and thus are unlikely to change on their own—can themselves affect the larger dynamics of European reforms. Thus, this paper foregrounds not the German response to proposals coming from Brussels or Paris—most of which elicit nothing more but polite yawns—but instead Germany's own policies and how durably these can be pursued inside a (hopefully) reforming and (clearly) troubled EU.

Laszlo Bruszt's manifesto for our workshop also rightly observe that the debates about the EU's future have not exactly obsessed either elites or voters of Central and Eastern Europe (CEE). At one level, it is hardly surprising that Jean-Claude Juncker's musing on the EU's future have generated little interest in Budapest, Warsaw,

[1] This leaves smaller reforms, such as former German Finance Minister Wolfgang Schäuble's proposal to turn the European Stability Mechanism (and intergovernmental institution) into some form of European Monetary Fund.

Bucharest and Tallin. Elites and citizens have focused much more on how to pursue economic convergence with Northwestern Europe (or even Southern Europe) and what kinds of production systems promise them the best future. And yet these questions can hardly be disconnected from questions about the future shape of the EU, as the organizers again correctly attest. Even the 'domestic choices' that seem to be key to issues of CEE catch-up and the associated niche strategies are, upon closer inspection, often not quite 'choices' and frequently are not exactly 'national.' Structural pressures from outside the CEE region matter a lot.

But how? As this question can be answered in so many ways, any one answer is necessarily incomplete, as indeed is ours. The organizing document asks for statements on '**diagnosis, principles, and reforms**,' however, and our paper, centered on the German-CEE relationship, does have something to say about each of these dimensions. Our **diagnosis** is that German policies pose deep challenges for CEE societies because, in (overly)stylized form, Germany has *externalized* its key economic problem—a persistent imbalance between surging domestic production and lagging consumption—to the rest of the world, while *internalizing* a key global problem—refugee flows—to the EU context. Both moves are enormously consequential for CEE. Indeed, we will argue that CEE nationalism is itself partly a consequence of learning the hard lessons of becoming a counterpart to German capital flows, which Southern Europeans and, now, Americans have also found extremely disruptive. Meanwhile, for a variety of reasons, Germany's refugee policy is also a huge challenge to the region, as most CEE states are reluctant to harbor refugees. Some have even been willing to defy the ECJ on this matter.

Our preferred **principles** include the idea that member states take more account of the externalities of their own national policies. One can be enormously sympathetic to German Chancellor Angela Merkel's decision to accept refugees, which ultimately led to between 900,000 and 1.2 million traveling to Germany over 2015-2016.[2] Yet even a cursory glance at the administrative and fiscal capacity required to manage this inflow raises some skepticism that CEE states could have taken in similar numbers in proportion to their own populations. Without excusing the embarrassing performance of those CEE states making essentially no contribution to the supra-regional disaster embodied by refugee flows,[3] it is understandable that these states could not hope in per capita terms to match the German effort, whether fiscally, administratively or politically. Meanwhile, externalities are also a key part of the economic debate, where Germany has long shifted income away from households and to firms and government. These shifts have increased national savings and decreased both consumption and (until very recently) also public and private investment. These policies subsidize exports, tighten skilled labor markets, and generate big export surpluses by undermining consumption and imports. German capital must then flow abroad, where if it flows to countries where growth

[2] Even if smaller number eventually applied for asylum. So far, 2017 numbers are down to roughly 15,000 per month.

[3] K. Scheppele, "Orbán's Police State: Hungary's Crackdown on Refugees is Shredding the Values of Democracy," *Politico*, September 14, 2015, at http://www.politico.eu/article/orbans-police-state-hungary-serbia-border-migration-refugees/

is not capital-constrained, it feeds into malinvestment, consumption booms, and unemployment (or all three in sequence—see Spain).[4]

Not surprisingly, our suggested **reforms** begin in Germany (though they do not end there). The road to a better-functioning EU begins in Berlin simply because Berlin is calling so many of the shots. In economic matters, Germany's disruptive trade surpluses are not driven simply by "high quality at low prices," as the German apologists like to say. They are driven also – and often much more – by financial flows that reflect policy-driven changes in incomes, consumption, savings, and investment. Of the three usual sources of growth – consumption, investment, and trade – Germany has grown disruptively reliant on the latter and has used policy instruments that tend to restrict the other two. This must change. Europe should strengthen the Macroeconomic Imbalance Procedure, and Germany should take it seriously—more seriously than is implied by the German government's regular statements that the current account surplus is going down. At the same time, we are less confident in our prescriptions on the refugee challenge. On the one hand, Merkel may well be right that "Germany can do it."[5] Certainly, many other (poorer) states nearer the chaos in the Middle East have taken far more refugees per capita than Germany and Sweden.[6] On the other hand, we agree that the perception of sustained, uncontrolled refugee inflows would likely generate enough anxiety to

[4] W. Jacoby, "Surplus Germany," Transatlantic Academy Policy Paper, May 2017.
[5] "Wir schaffen das."
[6] S. Dullien, "Paying the Price: The Cost of Europe's Refugee Crisis." *European Council on Foreign Relations,* April 2016, http://www.ecfr.eu/page/-/ECFR_168_PAYING_THE_PRICE_-_THE_COST_OF_EUROPES_REFUGEE_CRISIS.pdf, pp. 6-12.

swamp even the most stable European democracy, including Germany.[7] Some numerical limits on refugee inflows thus seem justifiable to us on pragmatic grounds.

Our agenda is different from the regulatory and monetary policy focus of much of the rest of the workshop. In fact, the main regulatory point in our first case—current account balances—is a negative one: the fact that member states lack tools to manage capital inflows is a major problem. Free capital mobility is a major innovation in the European Union and, in some quarters, a highly prized accomplishment. But capital inflows in non capital-constrained economies can be immensely disruptive, something the IMF and other IOs have increasingly recognized.[8] Meanwhile, there is essentially no settled regulatory politics in our other core case, the issue of refugee flows. To be sure, there is a European Regulation (Dublin III) that purports to determine how refugees are processed and distributed. German policies effectively led to this regulation being (practically, if not legally) set aside in 2015. The issue since has been how to construct a legitimate and functioning regulatory apparatus for the 28 member states.[9]

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[7] I. Krastev, *After Europe*, (Philadelphia: University of Pennsylvania Press, 2017).
[8] R. Stone, *Lending Credibility: The International Monetary Fund and the Pot-Communist Transition*, (Princeton: Princeton University Press, 2002); M. Buszko and D. Krupa, "Foreign Currency Loans in Poland and Hungary: A Comparative Analysis," Procedia Economics and Finance, November 2015; K. Pistor, "Into the Void: Governing Finance in Central & Eastern Europe." SSRN Scholarly Paper 355. Columbia Law and Economics Working Paper. New York: Columbia University, 2009, http://papers.ssrn.com/abstract=1476889.

Our preferred diagnosis, principles, and reforms amount to a tall order for German politics, and we are aware that our suggestions are unpopular there. As noted, the recent Bundestag elections seemed to us to push Germany farther away from these suggestions. Speculation has centered on a likely CDU-FDP-Green ("Jamaica") coalition, and exploratory talks are underway in Berlin. This is worrisome. Substantively, lowest common denominator politics will likely center on areas such as tax reductions, helpful in raising German consumption and imports but well short of the needed reforms. The FDP, which has signaled its intention to take the Finance Ministry, has rejected all proposed innovations at the level of the European economy with the possible exception of a (likely largely symbolic) European Finance Minister. With the ECB pursuing quantitative easing and the troubled EMU member governments using the resulting breathing space from bond markets to soften austerity policies, growth has returned to the Eurozone, and larger fixes—along the lines of European investment programs, debt mutualization/forgiveness, or broader unemployment schemes—are likely to face a very stiff opposition from the German government. On the refugee question, however, there is movement: the CDU has agreed in principle to a longstanding CSU proposal to limit refugee inflows to Germany to 200,000 per year.[10] The FDP will go along. Whether the Green Party agrees to this in coalition negotiations remains, of course, to be seen.

[10] So far, Merkel has insisted this limit be an informal agreement, with no constitutional change in the right to asylum in Germany. See German Ministry of Interior Press Release, October 11, 2017.

With this sketch of our broad concerns, we turn now to two case studies—on trade and capital flows and on refugees—and investigate the links between Germany and the CEE region. We conclude with a discussion of why it makes sense to think about these two very different policy domains together in one paper. A common thread is that each of the two "German problems" externalizes costs and forces other countries to adjust to German policies.

Problem 1: Germany's Goods Surplus Forces Painful Adjustments Abroad

To see the roots of some of the last decade's most difficult economic problems, we need to go back to German behavior in the early days of the European Monetary Union. This is true even in countries that were not part of EMU, such as most of those in CEE.[11] Germany's central economic problem of the late 1990s and early 2000s was unemployment. Its traditional answer to employment difficulty had been to subsidize its powerful manufacturing export sectors and to hold down cost rises to levels below prevailing inflation rates.[12] The problem was that this technique had always been limited by the corresponding tendency of the national currency to appreciate as soon as export surpluses rose. The mechanism through which this happened was, at heart, fairly straightforward, even if more complex in practice: as foreign buyers chased German goods, their demand for the D-Mark increased, and

[11] Only Slovenia joined EMU at an early stage and prior to the crisis onset, followed later by Slovakia and the Baltic states during and after the crisis.
[12] J. Bibow, 'How Germany's Anti-Keynesians has Brought Europe to its Knees,' /www.levyinstitute.org/publications/how-germanys-anti-keynesianism-has-brought-europe-to-its-knees

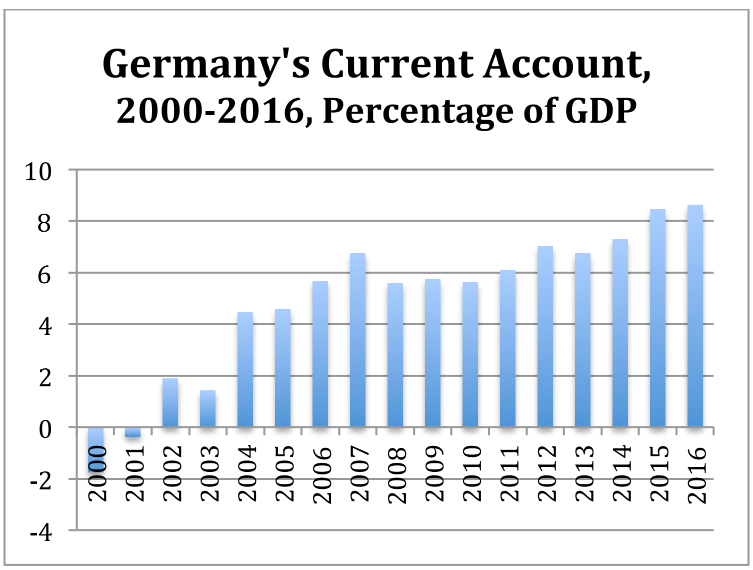
this higher demand pushed up the value of the currency. The stronger currency would stimulate German imports and hurt German exports, generally keeping the German goods surplus in a modest range.[13]

The advent of the euro weakened this feedback mechanism, and when Germany's traditional reliance on holding wage growth below inflation reached a new inflection point with the Hartz reforms, German consumption stagnated and then declined. In fact, as German growth outstripped consumption for several years running in the early and mid-2000s, German labor markets did tighten, but German savings then necessarily rose. Indeed, this *had to happen* because national savings is simply the difference between national production and national consumption. Since —as we show below—German production went up and consumption went down, German savings had to rise. This had major implications for the rest of Europe, which had few institutional tools for managing capital inflows since free movement of capital had become a major emphasis of the post-Maastricht EU. In a nutshell, our argument is that these capital inflows, because they were driven much more by the supply of capital from Germany than the demand for capital from peripheral Europe, tended to end in investment and consumption bubbles. In the intervening years, of course, the unemployment that was Germany's central problem in the early 2000s has largely abated, and the new German problem is the resulting persistent imbalance between surging domestic production and lagging consumption.

[13] Today, with currency markets exploding in size, more factors have to be considered, but this is a reasonable approximation of one historical link between trade balances and currency values.

Germany, we will argue, has *externalized* that problem, first to Southern and Eastern Europe and much later to the rest of the world, including the United States.

The *fact* of Germany's large current account surplus is not in doubt, only its causes and implications. Figure 1 shows, Germany's current account moved from negative territory – where it had been through much of German reunification – into large surpluses by 2004.[14] In recent years, the surplus has been around 8% of GDP and is driving much of Germany's growth. Why? Put broadly, any national economy in an open international order has three primary sources of growth: domestic consumption, domestic investment, and net trade. Because Germany now has both low consumption and low investment, it has come to depend on exports for growth.



[14] Technically, the current account is more than trade. It is a country's net balance in traded goods and services, net income on its overseas investments, and net "transfers" (especially remittances). Of these components, the trade portion is, by far, the largest. The trade account also closely approximates Germany's current account since the other components (small deficits in trade in services and remittances and a small surplus in secondary income) usually balance out.

This pattern of export-led growth is not entirely new, of course. Post-WWII Germany has always used an export-led growth model, and yet the resulting surpluses were generally low (often under 1 percent of GDP) with surges short-lived (e.g., the late 1980s). What has changed are Germany's demographics, Germany's wage and wealth distribution, and, crucially, a number of its policies in the labor, welfare, and fiscal domains. Germany got much older – among major economies, only Japan and Italy are similarly aged – and it now has far more inequality than it used to.[15] Both factors lead to even higher national savings than normal, and both factors also depressed investment. Since extra savings not used domestically are, by definition, exported, this shifts demand abroad, which is reflected in a trade surplus.[16] The introduction of the euro exacerbated these trends, as the usual mechanism to restore balance was the appreciation of the currency of surplus countries. Moreover, Germany also raised taxes on consumption, cut taxes on business and constitutionalized balanced budgets. These choices further depressed

[15] Fratzscher, *Verteilungskampf*.
[16] Excellent introductions to these dynamics are M. Pettis, *The Great Rebalancing: Trade, Conflict, and the Perilous Road Ahead for the World Economy* (Princeton, New Jersey: Princeton University Press, 2013) and E. Jones, "Shifting the focus: The new political economy of macroeconomic imbalances," *SAIS Review*, 29(2), (2009), pp. 61-73. Econometric studies that show the relative contributions of savings and competitiveness in German trade patterns include R. Kollmann, M. Ratto, W. Roeger, J. in't Veld, and L. Vogel, "European economy: What drives the German current account? And how does it affect other EU member states?," European Commission Report, *Economic Papers*, vol. 516, April, 2014, http://ec.europa.eu/economy_finance/publications/economic_paper/2014/ecp516_en.htm.

domestic incomes and/or increased reliance on demand from abroad. The result is a country that leans very hard on external demand.[17]

German policymakers and their apologists in the German media generally account for the export surplus with reference to superior German engineering.[18] But there is scant evidence for a sharp increase in German product quality in recent years. Instead, Germany's trade surpluses are not primarily the result of cost control and great products alone but the necessary complement of capital outflows, whose causal weight can "dominate" the trade balance in the age of financial globalization.[19] Trade surpluses are not a sign of a country "winning," as the annual celebratory "export world champion" stories in the German press often imply. They are, instead, often a sign of major mismatches in a country's savings and investment rates.

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[17] Exports account for roughly *half* of Germany's GDP (the OECD average is just under 30 percent).

[18] For examples, see Jacoby, "Surplus Germany."

[19] Pettis, *The Great Rebalancing*; K. Austin, "Secular Stagnation and Two Articles of Faith of the Conventional Wisdom," *World Economics*, 17(3), 2016, http://www.world-economics-journal.com/Secular%20Stagnation%20and%20Two%20Articles%20of%20Faith%20of%20the%20Conventional%20Wisdom%20.details?AID=648, pp. 55-90; P. Temin and D. Vines, *The Leaderless Economy: Why the World Economic System Fell Apart and How to Fix It*, (Princeton, New Jersey: Princeton University Press, 2013); Baldwin et. al., "Rebooting the Eurozone: Step 1 – Agreeing a Crisis narrative;" E. Jones, "Shifting the Focus." A more technical version focused on gross capital flows rather than net flows in the current and capital accounts has been pioneered by H.S. Shin, "Global Savings Glut or Global Banking Glut?" Vox (EU), December 20, 2011, http://voxeu.org/article/global-savings-glut-or-global-banking-glut.

The indicator that best captures this change in Germany is national savings, which grew from roughly 21 percent to 28 percent of German GDP during the period in question (2003-2017). Why should it matter to other countries, including those in CEE, how much Germany saves? Because national savings don't just sit in banks. Rather, they are invested, either at home or abroad. And since global savings and investment *must* equal one another by definition, savings *increases* in one place logically *must* be matched either with investment growth (there or somewhere else) or by savings *declines* somewhere else.[20] Broadly, Germany is one of a number of countries, including China, Japan, and South Korea that are now saving far more than they are either consuming or investing (a country's GDP is the sum of its consumption and investment, and, since all GDP is income for the nation's residents, another way of putting this is that GDP is the sum of consumption and savings – the two things people can do with their income.).

What happens to those "extra" savings (e.g., in excess of the nation's total investment)? According to macroeconomic theory and data, *they are going to any country with a trade deficit*. Indeed, another way to understand a country's trade surplus is that it is (and must be) exactly equal in size to its investment deficit.[21] The literature on capital flows foregrounds the importance of this relationship and spells out a number of its counterintuitive and often unwelcome results, including how

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[20] Pettis, *The Great Rebalancing*, pp. 29-32, 50-52; Austin, "Secular Stagnation."
[21] Technically, central bank reserves play a part in this balance, along with "errors and omissions."

difficult it is for countries to deal with unneeded capital inflows when their current investment needs are largely covered.

Thus, where German officials tend to claim Germany's trade surplus is simply the aggregate result of free consumer choices, it is actually mostly the result of Germany's capital outflows, which themselves are the result of policy choices that shift national income from consumers to firms (as profits or capital subsidies) or to the government (as budget surpluses). Global capital flows have their own logic and have now grown to dwarf trade flows. Countries that persistently save more than they invest, often generate concerns among their commercial partners, either regionally or globally or both.[22]

All of this brings us back to Central and Eastern Europe. Germany's excess savings—that is, in excess of what was invested domestically—flowed outward in many directions, particularly to places with higher inflation rates, which reduced real borrowing costs to very low levels. As anticipation of EU membership became more realistic, political risks seemed to decline further in CEE, but capital also flowed to places like Turkey that had less realistic chances of membership. Some of this capital found very productive uses in a region with high skills and low wages, and so-called 'wealth effects' kept demand for more capital at high levels. As savings flowed in from abroad, investment could rise for a time to keep up. Over time, however, CEE savings had to fall in order to compensate for the vast amounts

[22] Pettis, *The Great Rebalancing*, pp. 128-135, 142-149.

coming in from Northern Europe (Germany was not the only country to figure out this game). Malinvestment in unproductive outlets (often in housing and real estate) was one short-term result, and debt-fueled consumption (the opposite of savings) was another. In the medium term, of course, liquidity sharply contracted after 2007, and the need to pay back German savers resulted in a very rough combination of internal depreciation and currency depreciation.[23] Southern Europe, which could not deploy currency depreciation, has tried to restore balances with internal depreciation alone.

Could these externalities—mostly negative but some positive—have been avoided? It's hard to see how. With free capital flows a part of eurozone rules and the liberal international order, there are few mechanisms for stopping such inflows. By the time German capital outflows spiked upwards in 2003, CEE states were in the final stretches of membership negotiations, which would have made capital controls quite difficult even if the full extent of the danger had been widely recognized. International banks were willing to lend, and many citizens in poorer transformational countries can hardly be blamed for accessing freely extended capital at historically good rates. It would have been exceedingly hard for the state to intervene in this process, although there is variation in how much the CEE central banks even tried to do so.[24] To repeat, the inflows, if they cannot be used productively, generate problems for receiving countries. Since savings must, again

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[23] Depreciation was used aggressively by Hungary, Poland and Romania, but not by the Czech Republic, Bulgaria (which pegged) or Slovakia (which joined the euro).
[24] Buszko and Krupa, "Foreign Currency Loans."

by definition, match investment, those inflows that aren't invested must generate lower savings in the receiving country. There are two main ways this happens: either through an (unsustainable) consumption boom or an (unfortunately quite sustainable) increase in unemployment.[25] Consumption decreases savings by increasing debt; unemployment causes savings to shrink as people live off past earnings.

What German policies most contributed to these outcomes? Several mechanisms were important, including redistribution of income away from lower-saving households to higher-saving businesses during Germany's Hartz reforms,[26] Germany's remarkably regressive social security taxes,[27] and (later) its increase in consumption taxes all pushed down household shares of national income (and thus pushed up national savings rates). Meanwhile, Germany's already lagging public and private investment mostly lagged further,[28] and the push factor of transnational banking,[29] combined with the pull factor of less-developed Southern and Eastern

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[25] For details on the mechanisms causing unemployment, see Pettis, *The Great Rebalancing*, pp. 104-106, 110-116; also M. Pettis, "Syriza and the French Indemnity of 1871-73," Carnegie Endowment for International Peace, February 4, 2015, http://carnegieendowment.org/chinafinancialmarkets/58983.

[26] Pettis, "Syriza and the French Indemnity"; Johnston, Hancké, and Pant, "Comparative Institutional Advantage."

[27] A. Hassel, "No Way to Escape Imbalances in the Eurozone? Three Sources for Germany's Export Dependency," forthcoming in *German Politics*, 2017.

[28] M. Fratzscher, *Die Deutschland-Illusion: Warum wir unsere Wirtschaft überschätzen und Europa brauchen* (Munich: Carl Hanser Verlag, 2014).

[29] C. Borio, H. James, and H.S. Shin, "The International Monetary and Financial System: A Capital Account Historical Perspective," Bank for International Settlements: BIS Working Papers, August 2014, http://www.bis.org/publ/work457.pdf.

states seeking Northern capital, sent these funds abroad.[30]

The evidence is compelling for a capital flows-focused approach, as it shows an important shift in the German economy commensurate with the onset of the trade surplus in 2003.[31] Consider the following trends, bearing in mind the central causal claims that a) policies can shift income from households to firms (or governments), thus increasing savings rates, either by growing profits or paying down debt; and b) that other policies can directly and indirectly affect investment rates: Between 2003 and 2016, German final consumption fell from 76.6 percent of GDP to 73.3 percent, private consumption fell from 57.7 percent to 53.6 percent, and household consumption showed an even more impressive drop from 56.1 percent to 51.8 percent. Over the same period, total domestic demand fell from 96.3 percent of GDP to 92.5 percent. Individual consumption fell from 69.3 percent to 66.4 percent. As consumption falls, we expect savings increases, which indeed jumped sharply. Net domestic savings more than doubled, from 4.1 percent of GDP to 10 percent over the period, and gross savings jumped from 21.1 percent to 27.7 percent.

Also consistent with this approach, German gross investment, which had already fallen off sharply from the mid-1990s unification period, fell further from 19.7 percent of GDP in 2003 to 19.1 percent in 2016. Government investment remained roughly stable across the period at 2.1 percent, though, as noted, this is well below

[30] Baldwin et. al., "Rebooting the Eurozone: Step 1 – Agreeing a Crisis narrative"; E. Jones, "Financial Markets Matter More."
[31] All data in this paragraph are taken from Haver Analytics.

the OECD average. With investment stable but savings way up, Germany's net lending abroad surged from 1.7 percent of GDP to 8.6 percent. As indicated in Figure 2, the increase in German household savings, while impressive on its own, is complemented by much sharper increases in German corporate profitability.[32] Again, the sharp increase around 2004 is consistent with the timing of the onset of Germany's current account boom and entirely consistent with the broad causal mechanisms of the capital account approach to trade. The difference between national savings of 21 percent and 28 percent in a $3.5 trillion economy is $245 billion, which is (as it must be) very close to Germany's 2015 current account surplus of €257 billion.

FIGURE 2

Source: Trading Economics, http://www.tradingeconomics.com/germany/corporate-profits.

[32] Profits not distributed to shareholders are a form of savings.

By helping push internal devaluation in the eurozone and in the crisis-hit CEE region outside the Eurozone, Germany (along with other Northern allies) has helped make current account surpluses the "new normal" in Europe. On the eve of the global financial crisis, 20 of 28 EU states (including all of the CEE new member states) had a current account *deficit*, and 7 of these national deficits were more than a whopping 12 percent of GDP.[33] Today, these figures have dramatically reversed, with 20 of the 28 current member states in *surplus*. Of the 8 states running a deficit in 2016, all were small deficits (e.g., less than 1 percent), except for Romania (2.3 percent), the UK (4.4 percent), and Cyprus (5.3 percent). Moreover, deflationary adjustments in the eurozone have pushed crisis-hit states from current account deficits to balance or surplus. The result is that the eurozone, which used to be in a rough trade balance with the rest of the world, now runs a current account surplus of about 3.4 percent.[34]

Stepping back, the borrowing binge in Eastern and Southern Europe is connected with a prior German savings binge that generated capital well beyond Germany's investment needs. Given EU rules, foreign borrowers had weak legal alternatives to accepting Germany's imported capital. German imports consumer demand from abroad precisely because it has taken policy steps to deny itself the capacity to consume its own product (or an equivalent amount of foreign products). Relatively

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[33] This paragraph uses Eurostat data for 2007 and 2016. http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tipsbp20&plugin=1.

[34] See "Euro Area Current Account" at Trading Economics: http://www.tradingeconomics.com/euro-area/current-account.

low German wages become problematic not primarily because they "undercut" other states but because they are part of a whole range of policies that depress German consumption and imports and, instead, import demand from other states.

This is all counterintuitive and much harder to summarize in pithy microeconomic analogies about Swabian housewives and nations-as-firms. What it means for CEE, however, is that while parts of the region have seen incomes grow through industrial FDI, other parts of the region have suffered from access to cheap capital that could not (or at least was not) used productively. Because the mechanisms at work are both extremely powerful *and* quite hard for ordinary citizens or even ordinary policymakers to understand, they generate a backlash that is determined but not coherent. In something like the way American politics has generated a ferocious but economically illiterate response to massive and sustained inflows of foreign capital in an environment where capital is already plentiful, CEE regimes have also generated half-coherent, angry nationalist economics with a focus on foreign banks more than on foreign manufacturing firms.

A host of excellent scholarship on the region has documented different facets of this growing dualism.[35] Research conducted using global input-output data that

[35] D. Bohle and B. Greskovits, *Capitalist Diversity on Europe's Periphery*. Ithaca: Cornell University Press, 2012); J. Drahokoupil, *Globalization and the State in Central and Eastern Europe: The Politics of Foreign Direct Investment*, (Abingdon: Routledge, 2008); R. Epstein, *Banking on Markets: The Transformation of Bank-State Ties in Europe and Beyond*, (Oxford: Oxford University Press, 2017); J. Johnson, and A. Barnes, "Financial Nationalism and Its International Enablers: The Hungarian Experience," *Review of International Political Economy* 22 (3) 2015: 535–69; G.

decomposes industrial value chains shows that upskilling in CEE is real and that returns are to higher skills are growing from already high levels (though not as fast as returns to capital). Meanwhile, both low-skilled workers and, to a lesser extent, medium-skilled are losing income shares.[36] This is not too different than the case in Germany, where returns to capital are higher than in any developed country except South Korea and where the divide between skilled and unskilled labor sharpens continually.[37] Indeed, where German service sector workers once earned 95% of industrial worker wages in the early 1970s, already by 2006, they earned, on average, just over 65% of industrial wages, with hotel sector wages well under half of industrial wages.[38]

While our intent obviously is not to make such dualist trends into a monocausal explanation for either rising populism at the national level or reform blockades at

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Medve-Bálint, "The Role of the EU in Shaping FDI Flows to East Central Europe," *JCMS: Journal of Common Market Studies* 52 (1) 2014: 35–51; L. Bruszt, "Multi-Level Governance—The Eastern Versions: Emerging Patterns of Regional Developmental Governance in the New Member States," *Regional and Federal Studies*, 18(5) 2008: 607–627; L. Bruszt and V. Vukov, "Making States for the Single Market: European Integration and the Reshaping of Economic States in the Southern and Eastern Peripheries of Europe," *West European Politics* 2017; D. Bohle, "The Political Economy of Housing Booms and Busts in Europe's Periphery," *Studies in Comparative International Development*, forthcoming, 2018; L. Podkaminer. "Development Patterns of Central and Eastern European Countries (in the Course of Transition and Following EU Accession)," Vienna Institute for International Economic Studies. Research Report #338, 2013; D. Bohle and W. Jacoby, "Lean, Special, or Consensual? Vulnerability and External Buffering in the Small States of East-Central Europe." *Comparative Politics,* 49(2), 2017, pp. 191-212

[36] M. Timmer, A. Erumban, B. Los, R. Stehrer, and G. de Vries, " Slicing Up Global Value Chains," *Journal of Economic Perspectives*, 28(2) 2014: 99-118, Table 2.

[37] Timmer et al, Table 4.

[38] A. Hassel, "No Way to Escape Imbalances in the Eurozone?" *German Politics*, Forthcoming 2018, Table 2.

the European level, we stress that Germany's economic preferences are both deeply rooted at home and disruptive abroad. Germany can import an outsized share of currently scarce global demand, but it can only do this by venting private, corporate and government savings to other states. Such states, in turn, have relatively few options outside domestic policies that restrain the demand for foreign goods among substantial sectors of the population. Increasingly, then, we see CEE states following the path Germany has blazed (and indeed the path taken by Asian countries after the current account crisis there in the late 1990s): reduce labor's share of national income, subsidize capital in exporting sectors, and hope the resulting inequality can be managed politically. But where Germany has a robust social state that redistributes market income quite aggressively, no such social state is available in CEE.

Problem 2: Germany's Refugee Policy Also Forces Adjustment Abroad

If Germany's economic policy since about 2003 has forced adjustment by its neighbors, German refugee policy since fall 2015 has done so as well. For the purposes of this paper, however, two important difference stand out. First, while the economic disruptions are extremely hard for both CEE elites and voters to connect to German behavior, no such difficulty exists on refugee policy.[39] To be sure, skeptical CEE politicians—led by Orbán but also Fico and, since the October 2015 elections, also Polish politicians—have inflamed public opinion across the Visegrad

[39] D. Bohle and W. Jacoby, "Dynamic Europeanization", Working Paper, 2017.

states to a more anti-refugee consensus than might otherwise have existed. But there is strong evidence that public opinion has come to see refugees as a major concern.[40] In all probability, therefore, official fear-mongering was not required to lead many CEE citizens to an anti-refugee position. Indeed, an expert survey by the Hungarian Europe Society found that 88% of respondents thought Visegrad state policies were motivated with an eye toward capturing popular support.[41] It is not hard to infer that many CEE citizens required no anti-refugee rhetoric from their governments to bring them to an anti-refugee position. An even stronger majority of 94% agreed that the their government had not "supported Angela Merkel's policy."[42]

A second difference is that while the economic case saw Germany *externalize* a traditional problem in its domestic political economy, the refugee case saw German *internalize* a global problem, with refugees coming not only from the Middle East (primarily Iraq and Syria), but also Africa (primarily Eritrea) and even Western Asia (primarily Afghanistan). To be sure, these refugees—some of whom had been in flight for months or even years—were headed for Europe no matter what Germany chose to do in 2015. But few doubt that Merkel's surprising decision in September 2015 constituted an important new dynamic in the overall events. In particular,

[40] Krastev, *After Europe*.
[41] I. Hegedűs et al, "The Refugee Crisis and the Reactions of the Visegrad Countries." *Hungarian Europe Society*, September 26, 2016.
[42] Hegedűs et al, "The Refugee Crisis." p. 8.

Visegrad politicians have stressed the role of German state policy and its associated *Wilkommenskultur* in civil society in sending a signal to refugees not yet in Europe.[43]

Due to a variety of factors, refugee arrivals in Europe surged in late summer and fall 2015.[44] On September 2, Merkel, in conjunction with then-Austrian chancellor Werner Faymann, opted not to close the so-called Balkan Route into Central Europe. Significant refugee inflows immediately followed. Of the 1.3 million refugees arriving in Europe in 2015, Germany alone received 890,000, with more than half that number submitting formal applications for political asylum by the end of 2015.[45] In 2016, the number of refugees entering Germany dropped to 280,000, however, the number of first time asylum applications rose to 722,000.[46] In two short years, Germany was gearing up to shelter and take care of 1.1 million people (Figure 3). While this number means an increase of more than one percent of Germany's total population, the number is not the only challenge.[47] The real test is how Germany will absorb and effectively integrate the refugees.

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[43] Hegedűs et al, "The Refugee Crisis." p. 17.
[44] For details, see R. Alexander, *Die Getriebenen: Merkel und die Flüchtlingspolitik: Report aus dem Innern der Macht* (München: Random House, 2017)
[45] S. Trines, "Lessons From Germany's Refugee Crisis: Integration, Costs, and Benefits." *World Education News+Reviews.* May 2, 2017. http://wenr.wes.org/2017/05/lessons-germanys-refugee-crisis-integration-costs-benefits.
[46] Trines, "Lessons From Germany's Refugee Crisis."; EUROSTAT, "Asylum Statistics." *EUROSTAT.* June 21, 2017. http://ec.europa.eu/eurostat/statistics-explained/index.php/Asylum_statistics.

[47] Trines, "Lessons From Germany's Refugee Crisis."

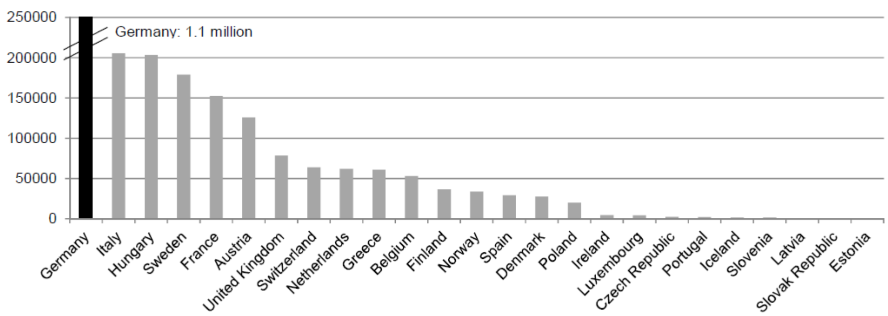

Figure 3: Asylum applications in 2015/2016, in European OECD countries, Germany highlighted (Source: Eurostat)[48]

Why did Germany pursue this policy? Currently, this outcome seems causally overdetermined, and the precise mix of motives is not central to this paper, though the most prominent hypotheses deserve brief mention. A humanitarian motive flowing from Germany's constitutional commitments made after WWII will have played some role. Indeed, this is the third major refugee wave Germany has absorbed, following that of the postwar expellees and the large surge from the Balkan wars of the early 1990s. Demographic and labor market concerns are often mentioned. Aging Germany has a very low birth rate with average female fertility around 1.4 (far short of the 2.1 replacement rate). Growing life expectancy also means potential funding gaps in the social security systems, and her awareness of large gaps in the labor market may have pushed Merkel to see refugees as a pool of future workers.[49] Some have speculated that Merkel may also have seen an

[48] OECD, *Finding their Way: Labour Market Integration of Refugees in Germany.* Research Paper, 2017 (Paris: OECD).

[49] M. Heise, "Population, ageining and immigration: Germany's demographic question." *World Economic Forum.* April 27, 2017.

opportunity to counterbalance a growing reputation for selfish behavior in Eurozone reform matters with a big-hearted gesture in refugee policy.[50]

The aim of this section is not to explain the German or CEE states' decision-making process but to take initial stock of how Germany is meeting the resulting challenge and gauge the extent to which it has had disruptive externalities in CEE. Our intuition is that if even Germany will struggle to integrated refugees, given its much longer history of taking in both refugees and immigrant labor, then the caution in CEE might be more understandable. To be sure, German difficulty would not excuse the paltry efforts that have been undertaken so far in cases like the Czech Republic (where only a comparative handful of refugees have been taken), let alone the stance of Poland and Hungary, which come very close to rejecting outright any responsibility for accepting and settling refugees.[51] Yet any full analysis of the refugee question—which many people accept is one of the central questions the EU must confront going forward—must contain some analysis of the logistics of this demanding multi-year process.

Germany cannot do it all alone and has sought a unified EU approach to integration. Dullien suggests creating a European Refugee Union that would centralize the effort to help refugees by creating a dedicated tax on the European level, process asylum

[50] W. Streeck, "Scenario for a Wonderful Tomorrow." *London Review of Books* 38(7) 2016, https://www.lrb.co.uk/v38/n07/wolfgang-streeck/scenario-for-a-wonderful-tomorrow, pp. 7-10.
[51] Scheppele, "Orbán's Police State." See also the discussion of how the Orbán regime effectively instrumentalized the Charlie Hebdo murders. Hegedűs et al, "The Refugee Crisis."

applications, host refugees and help resettle them in Europe if asylum is granted.[52] However, Europe still does not have a unified approach because its advocates face stiff opposition from a number of European countries, mostly in the Visegrad block. Dennison and Janning note, however, that the position of the Visegrad states allows other EU countries to hide behind the "groups' recalcitrance."[53] Krastev labels these countries as disappointed, distrusting, and forgetting their own past.[54] Yet while there is an element of fear, the CEE countries' decision to not follow suit on German preferences over refugee issues is more complex than that. It is not only the matter of national identity and culture, nor exclusively one of economic costs; instead, there is also a matter of pride – being seen as an equal contributor to the EU project, not only in execution but in development of policies. As a result, countries such as Hungary, which has had among highest number of refugees transiting through, and Slovakia which has seen only a few, have a similar stance of rejection of Germany's 'open borders' ideology.

Adequate integration of refugees brings financial burdens, which many of CEE countries are unwilling and unable to bear at this time. Katz, Noring and Garrelts outline seven tasks of holistic refugee integration; namely provision of (1) housing,

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[52] Dullien, "Paying the Price," pp. 6-12.

[53] S. Dennison and J. Janning, "Bear any Burden: How EU governments can manage the refugee crisis." *European Council on Foreign Relations.* 2016. http://www.ecfr.eu/page/-/Bear-Any-Burden_Dennison-Janning.pdf, p. 2.

[54] I. Krastev, "Eastern Europe's Compassion Deficit." *New York Times,* September 8, 2015. https://www.nytimes.com/2015/09/09/opinion/eastern-europes-compassion-deficit-refugees-migrants.html.

(2) education, (3) language acquisition, (4) job training and labor market integration, (5) physical and mental health care, (6) access to services, and (7) security. While a full accounting of these costs is beyond the scope of this paper, Table 1 below uses IMF data to show how much financial burden federal and local governments now bear in Germany. IMF estimates show Germany's fiscal investment into asylum seekers ran at 3.1 billion Euros in 2014 (0.08% of GDP), increasing to 12.1 billion Euros by 2016 (0.35% of GDP). Germany's Ministry of Finance estimates are much higher, suggesting Germany has invested 21.7 billion Euros in 2016, with an additional 21.3 billion Euros envisioned for 2017 (or 53 Euro per person per day).[55] Trines concludes that this "amount, which includes preventive measures like humanitarian aid in crisis countries, as well as financial aid to countries like Turkey and Greece, represents more than half of the country's current annual defense budget of 37 billion Euros."[56] While CEE countries—several of which are in the excerpt in Table 1—lag well behind with their spending, their current economic situation likely would not permit an investment of €53/day per refugee/asylum seeker. And yet how can EU member states justify outlays of essentially zero in the face of such a situation?

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[55] Finanzministerium Deutschland, "Flüchtlingskrise kostet Deutschland jährlich 22 Milliarden Euro." *WELT N24,* January 27, 2017. https://www.welt.de/politik/deutschland/article161565378/Fluechtlingskrise-kostet-Deutschland-jaehrlich-22-Milliarden-Euro.html.

[56] Trines, "Lessons From Germany's Refugee Crisis*.*"

Fiscal Cost of Asylum Seekers, 2014-16[1] (Percent of GDP)	2014	2015	2016
Austria	0.08	0.16	0.31
Belgium	0.07	0.09	0.11
Croatia	0.002	0.09	0.11
Cyprus	0.003	0.012	0.012
Czech Rep.	0.0	0.0	0.02
Denmark	0.24	0.47	0.57
Finland	0.09	0.13	0.37
France	0.05	0.05	0.06
Germany	0.08	0.20	0.35
Greece	n.a.	0.17	n.a.
Hungary	0.0	0.1	0.0

Table 1: Fiscal Cost of asylum seekers, as estimated by European countries. Source: IMF[57]

Table 2 shows what is at stake for German cities using the case of Hamburg, which incurred costs of at least half a billion Euros in 2015, with higher estimates for the years 2016-2020, considering the recent increase in asylum applications.[58] Again, it is easy to conclude such outlays are beyond the reach of CEE municipalities without justifying the low level of effort many CEE cities have made to date.[59]

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[57] This would mean an annual investment of 11,000 Euros per person for 2016 (or an average of 30 euros per person/per day). S. Aiyar, B. Barkbu, N. Batini, and et al. 2016. *The Refugee Surge in Europe.* Discussion Note, na: IMF.

[58] B. Katz, L. Noring, and N. Garrelts, "Cities and Refugees: The German Response." *Brookings.* September 18, 2016. https://www.brookings.edu/research/cities-and-refugees-the-german-experience/, p. 16.

[59] Here, we would like to include realistic estimates of costs incurred in Budapest in fall 2015.

TABLE 2: BREAKDOWN OF COSTS OF SERVICES DELIVERED TO REFUGEES BY HAMBURG IN 2015	
SERVICE	**COSTS (IN MILLION EUROS)**
Creation and maintenance of initial reception centers and emergency reception centers	147.4
Health care for refugees in central initial reception centers	6.8
Health care for refugees in consecutive reception centers	45
Transportation of refugees	0.3
Security staff	20.1
Creation of consecutive reception centers	126
Maintenance reception centers	37.3
School affairs	32
Expenses according to asylum welfare bill	63.6
Initial care and consecutive care of unaccompanied minors	107.7
Total	586.2 million euros

Source: *Breakdown of costs of services delivered to refugees by Hamburg in 2015, source: Hamburg city government.*

Source: Hamburg City Government

Even our initial analysis and estimates provide a prima facie case that refugee integration along desirable lines would be very costly in CEE. The refugee crisis has widened the rift between Germany and the CEE countries and has been a far more visible source of tension than the trade and investment issues covered in the paper's first half. And unlike the trade and investment case—which has generated a backlash in Hungary and Poland but not in the Czech Republic and Slovakia—the refugee crisis has seen the states more in line with one another (and at odds with Germany). Moreover, the Visegrad states have gained some traction with their reservations, not only in the broader CEE space but indeed among other (including older) member states.[60]

There seem a great many reasons why CEE voters and elites might reject German exhortations to accept refugees fleeing violence and destruction. Ivan Krastev attributes what he calls "Eastern Europe's compassion deficit" to a number of overlapping factors:[61] fear of a return to multi-ethnic societies associated with the harshest periods of the 20th century; anxiety about the population decline, falling birth rates and outmigration of their ethnic nations; the prior failure to integrate Roma minorities; fear of labor market competition; the residue of Soviet-era anti-cosmopolitan campaigns; an enthusiasm for the 19th century German idea of the nation as ethnically homogenous; the lack of a colonial history and thus a sense of guilt towards peoples of Asia and Africa.

With CEE animosity towards refugees causally overdetermined, how might Germany begin to win skeptics back towards a common position? We suggest three important steps, while acknowledging that if Krastev is right, even these will not be enough. First, there is a need for some form of "reset," an informal moratorium on leading German officials commenting caustically on CEE reluctance to follow Germany's lead.[62] Germany's leadership is often perceived in CEE as self-serving, so

[60] Dennison and Janning, "Bear Any Burden."
[61] Krastev, *After Europe*, pp. 44-59.
[62] For example, former German President Gauck's statement that he found it "difficult to comprehend how nations whose citizens were once politically

it is little wonder that CEE countries often will not follow blindly. Worse, while individual CEE states have been angered by German policy on a variety of topics since becoming EU members, the refugee crisis seems to have unified the CEE states much more than, say, bailout policies in the wake of the economic crisis. We remember, for example, the very uneven CEE support for Hungarian proposals for an EU rescue package for the region in 2007-2008. "Visegrad cooperation" used to be an oxymoron. More recently, however, we've seen more coordinated CEE action. Not only did the CEE countries refuse to act as Germany wished (and as prescribed by the European Court of Justice), their vocal reluctance to share the refugee burden probably strengthened other far-right and populist movements across Europe, as well as that of the AfD in Germany. Where pressure on CEE parties, leaders or countries is deemed essential, German officials must take care to act in concert with many other member states.

Second, Germany will need to tread carefully in its own traditional use of migrant workers from CEE. Germany has a long track record of employing skilled workers from the CEE countries. It has continued to do so in 2014 and 2015, to compensate for the lack of labor force, employing on average 533,000 foreigners annually.[63] Germany's eagerness now to include many refugees into the labor market both fulfills a pressing need, but also implies less German dependence on skilled workers

oppressed and who experienced solidarity can withdraw their solidarity from the oppressed from other places."

[63] Der Spiegel, "Deutscher Arbeitsmarkt braucht mehr Ausländer," March 27, 2015, http://www.spiegel.de/wirtschaft/soziales/zuwanderung-deutscher-arbeitsmarkt-braucht-mehr-auslaender-a-1025834.html.

from the CEE countries. This need not be a source of tension if carefully managed. As their own populations decline, CEE countries will be eager to keep their skilled workers at home. However, remittances, long a source of increased consumption at home, would then decline.[64]

A third point that Germany (and EU as a whole) will need to consider is the future of some of European Union's core values in the wake of greater insecurity within the EU. Germany's attempt to show solidarity with refugees quickly became a point of contention at home (with the resurrection of the nearly-dead AfD in fall 2015) and with the CEE countries. Not only did it create political disillusion, but it also tested European security strengths (e.g., the Berlin Christmas market attack was perpetrated by an asylum seeker), likely pushed Brexit from a losing electoral proposition to a winning one, and clearly revealed striking gaps in European solidarity. While this solidarity with refugees has improved millions of lives, it has come at high cost, one that the newly-elected leadership across Europe might not be willing to pay in the long term. As a result, the ongoing reform debates will need to address the relationship between loyalty to European humanitarian values, rule of the law, and security. As Dullien suggests, creating a European Refugee Union could help the EU continue its humanitarian effort in a more unified manner, without giving up its security.[65] However, such a union would need to be instigated and built with CEE countries' approval and assistance. Whether that is possible with the

[64] Bohle and Jacoby, "Dynamic Europeanization."
[65] Dullien, "Paying the Price," p. 10.

current state of affairs remains to be seen but strikes us as likely only if the numbers of refugees assigned to CEE for the near future is little more than symbolic.

Of course, even if the new German leadership practices skillful diplomacy and gradually distances itself from the impression that Germany would try to absorb nearly unlimited numbers of refugees, the highly visible aftereffects of the policy will reverberate in CEE. If, over time, Germany manages the complex labor market, cultural, educational, and domestic security implications of a substantial refugee population, it is conceivable that CEE states may make more efforts in that direction, perhaps rediscovering their own labor market needs, history of integrating co-ethnic refugees and recalibrating worries about demographic changes in a less ethnically homogenous sense. That day, if it comes, remains distant. For now, Germany's decision to internalize a global problem has been met with fierce and, we think, durable resistance in CEE.

Brief Concluding Thoughts

This paper has looked at two quite different policy domains: trade/investment and refugees. It argues Germany has been predictable in one area, erratic in the other and dangerous for CEE in both. In turn, the externalities—seen and unseen, visible and invisible—have helped drive CEE politics in a more national-populist direction. To be sure, the forces we document exist alongside other forces driving populism, and no effort has been made in this draft to disentangle these causal relationships. Evidence has been deployed in an illustrative fashion rather than systematically and for the purpose of exploring ideas seldom linked together in the European reform debate.[66] Our analysis points an accusing finger at Germany, but in no way is this meant to excuse the abhorrent behavior of many of the CEE region's most high-profile leaders. The shredding of constitutional norms and undermining of institutions is cause for great concern, and that is not Angela Merkel or Wolfgang Schäuble's fault.

At the same time, we insist the dynamics we emphasize are both important and related to one another: we have showed how the widespread movement towards export-oriented manufacturing in CEE tends to widen disparities in economic returns to skills. In turn, this trend away from decent returns to low skills not only exacerbates domestic inequality, but of course it is likely to pit whatever refugees might achieve residency in CEE against native workers in the low wage service sectors.[67] Thus, if a key governance task for CEE states was to learn to benefit from foreign capital without being swamped by it, their techniques for doing so has tended to make them even less capable of integrating refugees into their national labor markets. Their defense against the German capital export machine was to make their own attenuated version of it; unlike Germany's, however, their miniature version generates rough balances rather than big surpluses, and their states and

[66] For an exception, see M. Matthiijs. 2016.
[67] Were refugees able to acquire the skills to compete for jobs in advanced manufacturing sectors in CEE, this judgment would have to be revised.

civil societies clearly lack the resources being devoted to refugees in Germany, Austria, or Sweden.

At some level, both elites and voters know this. They also seem to feel—and fear—the tensions that result from even small numbers of refugees. While it is tempting to mock this parochialism in the context of tragedies in Syria and Iraq, these fears are also understandable. As Dancygier's work on the United Kingdom shows, there is a recipe here for substantial conflict, either migrant/refugee versus native (in the less likely event that CEE parties defend migrant access to public goods like housing, education or public employment) or migrant versus state conflict (in the more likely case that they do not).[68] Meanwhile, even if labor markets are relatively open, if refugees in CEE have high reservation wages—the amount required to move an individual into a job—the resulting reliance on the already-modest CEE social state will likely breed more resentment. That these tensions exist in many states outside CEE helps us understand that while the CEE states are posterchildren for their current reluctance to take refugees, they are hardly alone.

What is to be done? The road is hard, but we think it starts in Berlin. Spending on refugees' education, training, housing and health care (including psychological health) is an important place to start, and it is to Germany's credit that they have done so. The German spending on refugees documented above makes an important contribution to both dilemmas in this paper and is a way of internalizing rather than

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[68] R. Dancygier, *Immigration and Conflict in Europe*, New York: Cambridge University Press, 2010).

externalizing. It increases domestic demand and domestic investment and reduces reliance on net exports. Europe needs Germany to do much more of this. How? The government urgently needs to reduce taxes on labor and consumption (especially the value-added tax), take a much more aggressive stance that moves public investment from the low end of the Organisation for Economic Co-operation and Development to the higher end, and find ways either to reduce soaring national savings rates or improve the investment climate for firms or both. Special investment funds – such as that already envisioned for transportation – might also be established for schools and hospitals. Minimum pensions could be established. Germany could more aggressively take the lead in European-wide initiatives in defense, refugee integration, border protection, and research and development. Germany's fiscal situation would worsen, as has the fiscal situation of every country obliged or inclined to accept savings inflows in excess of what can be profitably invested. Absent significant reform in Berlin, the chances of addressing Europe's underlying problems are slim. Yet as long as German public culture insists its surpluses are unproblematic for others, it will understandably feel it has license to refuse such policy adaptations. If that refusal persists—or even worsens with an FDP Finance Ministry—treaty reform or no, we fear the forces of disintegration will continue to gather strength, not only in Europe but across the Atlantic as well.